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ROUNDTABLE HEARING ON REFINED INCENTIVES TO AVOID LOSS OF STOCK THROUGH PREPAYMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 566

THE NATIONAL AFFORDABLE HOUSING ACT

TO AUTHORIZE A NEW CORPORATION TO SUPPORT STATE AND LOCAL STRATEGIES FOR ACHIEVING MORE AFFORDABLE HOUSING; TO INCREASE HOMEOWNERSHIP; AND FOR OTHER PURPOSES

JUNE 20, 1989

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ROUNDTABLE HEARING ON REFINED INCENTIVES TO AVOID LOSS OF STOCK THROUGH PREPAYMENT

TUESDAY, JUNE 20, 1989

U.S. SENATE,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:03 a.m., pursuant to notice, in room SD-538, Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, Bryan, D'Amato, and Pressler.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. The hearing will come to order.

I thank you all for your presence, and I thank you for coming early to get ready for today's hearing on a very complicated and very controversial issue.

I welcome all of you.

This morning's hearing concerns one of the most pressing and controversial issues facing this committee and the Congress, the impending loss of hundreds of thousands of affordable housing units that were financed with HUD assistance under the old section 221(d)(3) and 236 programs.

This problem was thrust upon Congress 2 years ago following action on the 1987 Housing Act. At the time the nature of the problem was not well understood. Members of Congress heard conflicting reports about how many projects were affected, we heard disagreement over how many low-income tenants could be displaced, we heard controversy over what Federal actions could be cost effective, and we heard disagreement over how to balance the interests of owners and tenants.

The Department of Housing and Urban Development, which should have taken responsibility, seemed to be the organization least informed of the facts and least interested in finding a solution.

What Congress did know was sobering. Thousands of tenants would face an untenable choice, either pay substantial rent increases or be forced to seek comparable affordable housing in a market where it simply was no longer available.

In the vacuum created by HUD's failure of leadership, a number of States and localities were searching frantically for ways to retain the low-income use of this housing. We would have had a

surge of rancor across the country just when we needed to build a new housing partnership between the public and private sectors.

I believe Congress did the best that could have been done at the time. The 1987 Housing Act provided a temporary solution that was designed to give Congress and the country time to consider recommendations from several private sector task forces.

Congress authorized a variety of new incentives for owners to extend low-income affordability for the remaining term of the mortgage or to transfer the housing to nonprofit or public ownership.

The law also protected low-income tenants from evictions or sharp increases in rent. It permitted prepayment only in cases where it would not harm long-established national objectives such as availability of low-income housing, access of low-income people to employment and housing opportunities for minorities.

In the last 2 years we have learned a great deal more about the complexities of the prepayment problem. Major contributions have been made by the Low Income Housing Preservation Commission, by the National Advisory Council of HUD Management Agents, by the Congressional Budget Office and by others.

Broad agreement has emerged on several basic points.

First, there is agreement that this housing is a valuable national asset. The Commission estimated that 70 percent of the tenants have incomes below 50 percent of the area median, and 90 percent of the population have incomes below 80 percent of the area median income.

Second, there is agreement that the potential loss of subsidized housing is large. The Commission estimated that some 243,000 units will be in jeopardy during the next 15 years.

Third, there is agreement that the problem is disproportionately located in my own State of California and in several other States with extremely tight rental markets, such as Massachusetts, Connecticut, New York, Maryland, and Illinois. The loss of units in such markets would be devastating to families and to communities.

Fourth, there is agreement that owners of this housing have differing circumstances. Some have owned their properties since the late 1960's. Others came into ownership through the wave of resyndication in the early 1980's. Still others are recent purchasers. Owners had varied objectives for developing or purchasing specific projects. And, therefore, we will have to explore a variety of solutions.

Finally, there is agreement that we can't afford to replace this housing. So we must find ways to preserve as much of it as is practicable. And we have to do that in a way that is fair to the interests of the owners, the tenants and the communities in which the housing is located.

I'm greatly encouraged that Jack Kemp is taking the initiative on this issue. Under his leadership HUD is finally stepping up to its responsibility. I intend to work closely with him to find an effective and fair solution that has the support of Congress and the administration.

Time is short. Provisions of the 1987 Housing Act expire next February. We simply cannot extend current law. We have to refine

it. The purpose of this hearing is to move us along toward a consensus on how to accomplish that.

We have an outstanding group of participants to help us this morning. I am grateful that you have agreed to participate, each of you.

This is the fourth roundtable hearing that the subcommittee has held. Many participants in the earlier roundtables have said that this format provides a more useful discussion of ideas among witnesses and subcommittee members.

I encourage you to be forthright about differences of opinion, and I also urge you to be brief in your comments so that everyone can participate.

I am particularly grateful to those of you who prepared advance papers for this subcommittee. Those papers and the list of issues that each of you have received should help focus our discussion this morning.

We have much ground to cover and a short period of time, and I will try to move the discussion along to include all these issues.

So without further delay, let us begin the discussion.

Let me again emphasize that we don't want long prepared statements. We want give and take, and most of all we want differences of opinion expressed. That's the way to sharpen our understanding. So when somebody says something that you agree with, and perhaps you will want to say so or expand upon that, but if you disagree, that will be the most important way for us to get different views and to seek to absorb them.

Later in the hearing we will turn to a discussion of possible changes in title II of the 1987 Housing Act, but before we do, I would like to concentrate on how the 1987 Housing Act has been implemented since its enactment. I would like your assessment based on your own experience.

So these two questions. In what ways has the 1987 act helped to retain the low-income affordability of this federally assisted housing and what are its most important weaknesses.

Let's begin with each witness mentioning both the positive and the negative aspect of the current law. If we could go around the table to start it. We may not go all the way around in this forum, but could I start with you and can you just give us one example of a positive and a negative aspect to the current law if you have the same in mind.

Ms. MELKONIAN. Well, I think the most positive aspect was that it represented the Congress' desire to act to preserve this stock and to give everyone affected a chance to step back and consider the different interests involved and what would be necessary to reconcile those interests. So the action itself was the most important thing.

Its weakness simply is, what we know we can incorporate into the process for preserving the housing and the other issues which should be addressed in the future, such as the question of a fair return to owners and what that really means.

Ms. JOHNSON. Well, I would agree that the act has been very effective in preserving the existing stock. I believe that there has only been one prepayment that has been approved by HUD under the emergency act.

One of the greatest problems has been implementation of the act. We are still in a situation where there are interim regulations. We do not have final regulations. The handbook for the 241 Equity Takeout Loan is still in clearance, and there has been a lot of confusion about what HUD is requiring in its plan of actions and the criteria that it will impose.

Mr. SIMONS. Mr. Chairman, I think the act is positive in the sense that has been said. It has created a desire to accomplish a balancing act between the interests of the owners and the tenants and the Government.

The objective is basically, if you read it, to create a voluntary program which will encourage as many owners to participate in the program as possible.

The negatives are the vagueness of the act itself, the failure of administration and, finally, the lack of resources, because it becomes a very difficult piece of legislation to administer without those resources. But that combined with the vagueness and the lack of administration has really resulted in nothing more than a moratorium to date.

Mr. ROZET. I would have to agree with the comments made. I think there would have been a debacle had the act not been passed and many projects would have been paid off with tremendous disruption and displacement of tenants, I think the act did stop that.

Obviously what Mr. Simons has said is true, the act stopped it, but gave us no way of proceeding to in fact meet the needs of both tenants and owners.

Beyond that comment, I would say the act identified the payoff of existing 20-year positions as a major area of preservation, and in truth I think maintaining the existing stock in good, usable condition for the foreseeable future is really what the act has to focus on.

The bill you now have speaks of a preservation department, and the whole concept of preservation needs to be addressed as a major housing policy and not just the 20-year payoffs. That I think is just one facet and the smallest facet of preservation.

Mr. GRADY. I also would agree with what has been said. I think that the act certainly prevented prepayment.

The other portion of the act which I would like to touch upon is that the act and the 1988 act emphasized the need for the continuation of the project based subsidies where they were needed. After strong congressional urging, HUD is finally moving. We have therefore seen a great amount of preservation which was certainly needed by those projects take place as a result of the act.

I think that the negative aspects of the act, however, are the ones that have been mentioned. There were not sufficient resources to fully implement the act and in many cases the intervening time has become a holding period while everybody is anxiously awaiting this next round.

Mr. EDSON. I sort of enjoy the question. In what way has the 1987 act helped to retain the low income affordability of federally assisted housing? It did it simply by placing a moratorium on it and of course it was effective.

But the weakness was that either through some of the drafting problems in the act itself and the way it was administered, it pro-

vided no real incentives, meaningful incentives for the owners, and that was the glaring weakness in the act I think far overshadowing its positive effect.

Senator CRANSTON. May I say this first group has been very well behaved and been very brief and direct, and I hope you all keep that up. [Laughter.]

Ms. YOUMANS. Shall we start with the disagreement now? I think that the act was a good first step. It brought a lot of people to the table. It also identified the problem, there have been lots of studies as a result of it, and we know what the problems are now. It obviously is an imperfect law, as many laws are, on the first go-around.

In terms of what its weaknesses are, I think one of the most glaring weaknesses is the omission of any language to facilitate the transfer of these properties to nonprofits so that you don't have to keep doing this over and over and over again, in another 20 years or another 15 years.

Other people have mentioned the fact that there is a lack of meaningful incentives, and I think this is right. HUD has not come to Congress and said "Here is what we need to preserve these units". I think nobody really knows what it will take. I think you need money and you need to keep going through this process. I think that is a good beginning.

Mr. SIFLINGER. I would agree with the positive aspects that have been discussed thus far. I would say that essentially this has given us an opportunity to think the issues through more clearly in almost a noncrisis situation.

On the negative side, in addition to the comments that we have heard, I would say that there is clearly a serious problem at HUD. I think one would have to question at least up until the time of the Kemp administration as to whether or not there is the will at HUD to implement it. Hopefully there is that will now.

I think we all have to question as to whether or not there is the expertise remaining at HUD to think this issue through and to develop the approach that is necessary.

Senator CRANSTON. Did you say the expertise remaining at HUD? [Laughter.]

Mr. SIFLINGER. Do they have it? Have they lost it?

Senator CRANSTON. We're hoping to get expertise there under Jack Kemp's leadership.

Mr. SIFLINGER. That's right. You hope that you can build on a base, but I think we have to agree that over the last several years there has been significant erosion of the Civil Service and that kind of expertise that HUD had at one time, and I think that has got to trouble us, and obviously the resource issue has already been mentioned.

Ms. ACHTENBERG. Just to add a few more limitations to the list that has already been generated, I think the short-term nature of the act in and of itself has presented a real problem because the climate of uncertainty created by that is not conducive to project restructuring. Most owners have preferred to sit and wait and see what is going to happen.

If you are a nonprofit purchaser trying to buy a building, it's very difficult to bring an owner to the table when there is a likeli-

hood that the whole law is going to evaporate in 6 months. So the duration in and of itself is a major problem.

The other thing I would just like to emphasize is that the lack of standards for defining critical issues like fair rate of return on investment has been a major stumbling block to implementation of the act because people bring to the table their own expectations, and with an agency that, as has been pointed out, doesn't have tremendous expertise or initiative up until now, the ability to fall back on a lack of standards has led to paralysis in many cases.

Ms. ROGERS. The Housing Act of 1987 bought us all time, but the time, unfortunately, has not been well used. It provided incentives that were useful beginnings and should not be abandoned, but insufficient in relation to the real tax credit and volume cap changes that are needed, and it has been ineffectively implemented, in my view, for three reasons, resource constraints, lack of both intent and capacity at HUD and, as was pointed out by Ms. Achtenberg, lack of clear standards for the applications. So even if there were capacity, nobody knows how and nobody agrees around the Nation.

Mr. BURGER. I think that on the positive side, we have been given time through the act to bring the industry together, such as we have in this meeting where we get diverse kinds of views, so we can come up with some realistic ways to preserve the housing that we're working toward preserving.

On the negative side, the problem that has impacted mostly on me really has been an attitude in some of the HUD area offices, not so much at the central office, but in the area offices, relative to whether or not there will be any prepayments going through that particular office at any time in the future. There seems to be at this point a negative attitude, and I think that is prevalent to more offices than one.

Mr. YATES. I would have a little different perspective than that. I think the positive step has been not bringing together the industry with this time that we've had and this temporary protection that we've had, but bringing this to a public policy issue. In fact, this is an issue which is far too important to be resolved within the industry per se. That approach is part of the reason there is a problem.

This needs to be seen by residents, by nonprofits and by local governments as a public policy issue of great importance. The primary issue is what will happen to half a million plus households. So there has been some time for that to begin to penetrate.

The negative is that that has not penetrated far enough. One reason is the noninclusion of residents in the original legislation and not being given a clear role, and also the role for State and local governments was not as clear as it could have been, and certainly the problem we have had at HUD has exacerbated that.

I'll just add that three of us on the panel met yesterday with high-level officials at HUD and discussed where they are going with this, and I think that we can bring the news that we will see a much stronger role for residents to the extent HUD proposals are advanced there.

Mr. EGAN. Mr. Chairman, I'm pleased to hear, as Larry has indicated, that "leadership at HUD" is no longer an oxymoron, and I am hoping that the kind of leadership that has been shown recently can make a difference.

I feel that the act could have worked. It's unfortunate that we have lost almost 2 years because the act established a framework within which deals could have been cut on a case-by-case basis with owners, with communities, with State agencies, with residents and with other interested parties.

But what was lacking in the act was, first of all, a funding of the incentives, which could have worked with funding and, second, a specific and prescribed process and timetable to make sure that HUD was put in a position of, in essence, being forced to make deals. I think deals sometimes have taken on pejorative connotations, but in this context they shouldn't.

What we need to do is set up a specific process and a specific timetable, fund the incentives and start making some deals now.

Ms. TORPY. Speaking from the perspective of a local nonprofit that has raised considerable local and State and private resources to acquire 221(d)(3) for the tenants and on behalf of the tenants, I would like to say that the act is extremely important, but in order to really serve us, we need the act to be extended and to be permanent. The uncertainty has made it difficult for us to negotiate and compete with the potential of the market should the act not be renewed.

Also, the lack of resources has made it very difficult for us to meet our goals of affordability and no displacement even with the assistance we have been able to muster.

I think it's important also that the issue of value be resolved so that when we go to the negotiating table we can come up with a price that meets our needs as well as gives the owner an incentive to deal with us the nonprofits.

Mr. LANDON. Mr. Chairman, I speak primarily as an owner who has gone through the process, or is continuing with the process of trying to negotiate with HUD on the preservation of a 221(d)(3). The act was very effective in eliminating prepayment by making it virtually impossible to meet the criteria established for prepayment.

The negatives are two-fold. In brief, there has been a tremendous cost associated with trying to implement the act at the specific project level. There is not only the appraisal cost, but also there are legal fees, the time delay, and the loss of economic benefit. These costs have been tremendous in my specific instance and could probably be extrapolated to others.

Second, I have observed that although the act calls for local and State participation, there is a tremendous reluctance on the part of the local and State bodies to do anything. Their response has been "let's see what HUD is going to do first, and then we'll see if we want to help. We want to keep this housing at its current stipulated use, but we are not going to put our cards on the table until we see what the other guy is going to do." It has been very frustrating.

Ms. PERCY. Speaking from a tenant's perspective that has lived in a 221(d)(3) project for the past 17 years, I would like to say that yes, the act was a beginning, it was a starting point, but I, too, would like to see it extended and permanent.

One thing that I am disappointed about is that the tenants were taken out of the act. The tenants were not notified or did not have any participation in this act, and I think that is wrong, and I think

that tenants should be allowed to participate in the decision-making that would affect their lives. It certainly has affected mine, and it has forced the prepayment issue.

I live in Hillvale Apartments located in St. Louis, MO, and my owner for some reason decided to prepay last year. We are now waiting on a litigation to see what the courts will say about this prepayment issue. So certainly I think that tenants should have a right to be included in the act, and I think that our opinions are important.

Mr. LEVINE. I think most of the points I would make have already really been made. The positive element of the act was clearly establishing the framework for negotiating settlements. The resource constraints people have talked about. The capacity issue at HUD I think is a real reason for concern. We are encouraged, however, by the provisions in the National Affordable Housing Act to elevate the placement of preservation within the structure of HUD.

One additional modest negative, regarding the 1987 act—some unanticipated technical concerns that inevitably arise when one is legislating on tight schedules. From the point of view of both the owner of the mortgage and HUD, there are a number of minor transactions affecting mortgages—everything from partial condemnation to income associated with easements that may shorten the term of a mortgage—that get caught up within the prepayment provisions. From Fannie Mae's point of view as owner of a good many of these mortgages, we have seen our administrative burden increase—not unreasonably, but it's there.

You asked for a little disagreement, and I guess I would modestly disagree with one of the recent comments about the State and local involvement in the issue. I'm sure it varies a good deal among jurisdictions, but we have found States to be increasingly active in trying to find solutions and increasingly willing to commit their own resources. I think that's an important avenue for the future, while not anticipating that they can do the entire job by themselves.

Mr. KOELEMIJ. Mr. Chairman, the creation of the 1987 act probably reflected the desperate situation we found ourselves in after passage of the 1986 Tax Reform Act and the fallout of that. It was somewhat un-American putting in the prohibitions, to prepay; it broke contracts and we put prohibitions on free enterprise in a sense, and I think the act did what it was supposed to do; it gave us time to deliberate and to find answers to the problems that had been created in the preservation issue.

I think in that sense and I agree with what others have said that with your leadership, through the work of the National Housing Task Force and some of the other groups that have studied this particular matter and hearings of this kind that we should be able to find some answers to the problem.

Senator CRANSTON. Thank you all very much. Does anybody want to enter any disagreement at this point with anything that was said by somebody else?

Mr. SIFLINGER. If I may, Mr. Chairman, I just would repeat what Marty Levine said. There are many States that are very much involved in the issue of prepayment. There are a number of States

that are willing to put resources on the table to assist the Federal Government, which ought to be the major player in this field.

Senator CRANSTON. What we have been getting now with just once around the room are good points and bad points of the current law that we have to cope with very early next year.

Do you have any comments at this stage before we go on to the next question?

OPENING COMMENTS OF SENATOR D'AMATO

Senator D'AMATO. Well, Mr. Chairman, as you are well aware of, this is a problem of enormous significance to a number of regions. California obviously, and New York State are faced with this dilemma on a State basis, like the Mitchell Lama projects. We keep moderating, and there have been some solutions that have been suggested are good, and some are draconian.

But certainly I think we've got to come up with a package that allows for flexibility. I would maybe like to get Larry's views on this, but we need the kind of flexibility that does not mandate across the board, but that will give to the various developers and projects in HUD the ability to respond to these unique situations.

Second, it's wonderful when you have brilliant staff and they can give you the bottom line. The staff tells me that we are going to be looking for a minimum of $15 to $20 billion in budget authority if we are going to maintain section 8's. It seems to me, that from what I've heard, everyone believes that that is an absolute necessity, i.e. section 8.

Does anyone disagree?

[No response.]

Senator D'AMATO. Everyone says that if you are going to maintain section 8 as an integral part, of the program, it is going to mean that there will be a lot of battles. If we get CBO to put it in the baseline, then I guess we are not violating Gramm-Rudman.

Is that correct?

[Senator D'Amato turns to his staff.]

[Laughter.]

Senator D'AMATO. This is technical stuff here. Well, I think they said they don't think it is violating Gramm-Rudman, and we had better hope and pray it's not.

Is that right?

STAFF MEMBER. That's right.

Senator D'AMATO. We don't mind deferring to our brilliant staff. [Laughter.]

I would hope that we could come together on this important problem, and it's going to take political will to get that consideration. That would seem to be No. 1 then, Mr. Chairman, getting that included in the baseline by CBO so that then the Budget Committee could recognize this, and I know that the chairman there will exercise his magic.

Senator CRANSTON. Thank you.

Senator D'AMATO. So we have to get the CBO and the Budget Committee then to move in this fashion. It is important to many families, particularly in this era when housing costs are astronomical and we are fighting for the extension of the tax credit with in-

terest rates. We've got an obligation to do something, and we certainly look for your help in attempting to give us the suggestions that legislatively will make it possible for us to deal with that kind of flexible legislation that I believe is necessary. Obviously everyone says that section 8 is necessary.

I think that those of you in the housing industry should also communicate that to Secretary Kemp, and to his people as to how important that is, because if we can get the Secretary involved in the process of soliciting consideration for the section 8 figures to be included in the baseline by CBO, a major part of the battle will be won.

So I would suggest that we look to him, those who are in the industry and those who represent the various tenant groups. We should take every opportunity to bring the problem and also one of the perspective solutions to the Secretary's attention, and I think we would have a very strong advocate and one that can help us carry the day.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you.

Any responses or comments to that in particular?

Mr. YATES. Could I just speak to that.

Senator CRANSTON. Yes.

Mr. YATES. As I mentioned I think before the Senator came in, we were at HUD yesterday, three of us here on the panel, and it was the assumption of the high-level staff we were dealing with, Mr. Humbert and Mr. Maddy, that the section 8's would be included in the baseline. So I think that is their position.

Senator CRANSTON. Good.

Senator D'AMATO. Well, I would not waste any opportunity to continue with the new Housing Commissioner designate as well as the Secretary to make that an important part, an integral part of their program and to have them pushing for it as well as Members of the Congress. That's good news though.

Senator CRANSTON. Several witnesses among you in your testimony that is written have pointed out we don't have one prototypical owner of this low-income housing. Different owners will require different types of incentives. Some have even suggested that these differences among owners should affect the way in which a fair and reasonable return on investment ought to be evaluated.

I think these insights are very important, and I would like to understand the differences as clearly as possible. So let me put these questions.

What are the most important differences among owners of federally assisted housing, how should national housing policy address those differences and what are the most appropriate ways in which an owner's return on investment should be evaluated?

Who wants to take off on that?

Yes, Bruce.

Mr. ROZET. Let me approach that perhaps from a little controversial point of view, and I know it will come back up again. I'm not so sure that there are differences, substantive differences in types of owners, nor do I know that the concept of fair return is necessarily a valid one in the final analysis of this problem.

An owner is an owner whether he was the original builder, whether he was a limited partner in a vast partnership that acquired the property 20 years ago, whether or not he was an owner because he bought into a syndication on a recent occasion or whether he is an owner because he bought the property from the owner who died and he bought it from his estate, as happens to be a recent major case in California. He is still an owner who owns real estate, and he is going to approach the problem as one of an owner of real estate, which is to say what is my ownership position worth.

And it seems to me that one comes down to the question of what is that ownership position worth assuming that there is no law that prevents him from realizing the value of his real estate.

He may be negotiable to a lower value because of public purpose or because of other circumstances, but in truth he is an owner. I don't know how you classify him differently than any other owner of real estate.

As to what his returns should be—his return is what he can realize through a negotiation. Understand, and I don't know Mr. Landon's circumstance, but I think he is an owner because he acquired property from someone with the intention of making a profit. I don't know that that makes him different than, for example, an owner in California who inherited the property from his father and suddenly says "what is my property worth?"

My position is that it must be public policy to protect the property for the tenants who exist there today, and that we can establish the value of that property based on the incomes that the tenants can in fact pay. That then creates a value. The tenants don't have to be disrupted or displaced. The Government has to bear some cost, but not an unusually high cost, and the owner will have to get less than he might have gotten had he had free reign to act.

But I don't think there is differentiation in owners, nor do I think anyone can calculate the concept of fair return.

Senator CRANSTON. Larry.

Mr. SIMONS. Senator, I would like to reinforce what Mr. Rozet just said. If we approach the problem from the real challenge, which is the affordability of rents to tenants, the issue of fair return may or may not be necessary to address.

When I hear fair return or fair rate of return or market value, it makes me think of rent control in our favorite State, Senator D'Amato, and this is an issue that will never get resolved.

On the other hand, we have a pretty clear definition of what we consider to be affordability of rents. We have now come up with a formula of 30 percent of income basically is the affordability of rents. And the problem in doing this and structuring it to give value is trying to structure it so that instead of having it 30 percent of income as the rent, having rents set at roughly 30 percent of the income of the levels we are talking about.

I think the Department is moving correctly when they start tiering say between 50 and 80 percent, going 50 to 60 percent, 60 to 70 percent and taking mid points within there. And if they took occupancy levels which were realistic, they would be coming up with rents that basically are within the 30 percent affordability range.

Some people would be favored by a point or two and others would be hurt by a point or two.

Finally, you've got to deal with the problem of the very low income and what happens with the expiration of section 8, and I don't think that we want to take a very narrow construction of the law putting the owner at risk for the failure of section 8 to be continued, and I think that is a very important thing.

I think the Department in the legislation they have now and the ability they have now could have established and can establish yet a program which will at least let people come to the table to see if it works, and affordability is the major criteria we are all interested in and affordability is what we should focus on.

Ms. MELKONIAN. I think that is a key goal, because whatever we do, if we don't wind up with affordable housing we haven't accomplished what we set out to do.

But I think we have to be concerned about the cost for exactly the reason that Senator D'Amato was talking about, that resources are limited, and tnat therefore we do need to explore the question of a fair return on investment because that is what drives the cost here.

Whether we are transferring income from tenants by raising their rents to 30 percent of income or whether we are transferring public subsidies so that the rent can be paid on behalf of the tenant, that is all being transferred to the owner.

I think we have to make some judgment about what is a fair amount to transfer, and therefore we have to look, I think, at what was invested, not just at what the value of these projects are as a result of the accident of being in an inflationary real estate market, but what in fact are the economic expectations and which of those expectations should we address and how should we address them.

For example, there are many passive owners in these ownership entities who expect nothing more than tax benefits. If they were able to leave those ownership entities free of a tax liability, most, if not all, would be glad do so, and that would reduce substantially the amount of cash that would have to be appropriated to solve this problem.

There is also a question of expectations in the sense that some owners have been in from the beginning, having not taken advantage of the many increases in government subsidies that came down the pike, both tax and direct subsidies, and have an expectation of the original bargain, which perhaps should be honored, and I think it should be honored.

There are also those who came at the end expecting to profit from an immediate windfall by conversion to a market rate. Those people detrimentally relied, but could be made whole by being taken out and the housing preserved for long-term low-income use, and then there are many owners in between who could be looked at, and a reasonable judgment made, as to what they expected and they could be rewarded for both the investment of capital and their entrepreneurial skills.

And in the end I think that's the basis on which this public/private partnership should rest. This is not just real estate. This is housing that was built over time with public involvement as well

as private dedication to a particular result, and it's that partnership that should be underwritten.

Senator CRANSTON. Yes.

Mr. EDSON. At the risk of being somewhat reactionary, I think we are getting away from the notion that the owner entered into a contract with the Government in good faith that after 20 years he or she would be free to operate the project without the use restrictions. That is a property right bargained for in good faith with an entity that should keep its promises.

Therefore, I think that the measure of fair return is what the market would give for that project absent the restrictions. Now in a real world of cost constraints, you probably cannot get there, but I think anything short of the suburbs of that is both morally wrong and legally wrong.

In my paper I suggest a different approach than sort of the cost based, inflation based approach that Marilyn does. I think that you can meet this goal of treating the owner fairly simply by paying him or her section 8 fair market rents because that is a market test, those are market rents and capitalized it would make the project worth what it would be on the market.

But that is the real fair return, and it can't start out from the owner's original equity with some arbitrary percentage added on to it or what the owner needs to make the project affordable to tenants.

Senator CRANSTON. Yes.

Mr. YATES. Two things. The first is that the National Low-Income Housing Coalition, for which I'm speaking today, does not just as a blanket matter accept the 30 percent of income as an affordable rent. That is something that is really an innovation, and we just want it on the record that certainly for many people 30 percent of income is a hardship for very low income, for large families and others. We hear this from tenants from around the country, and it's something that is raised constantly.

So just on the record that's not something that descended from Sinai, but it was something that was worked out as a political compromise quite recently.

The other thing I would want to say is that I think the appropriate way to look at owners, and I think Mr. Rozet expressed it very clearly from an owner point of view, but I think from the public policy point of view what we are talking about is vendors to the Government of a very complex service-product combination. And what we need to do from a public policy point of view is see are they the right vendors, should we find other vendors and how is this best provided.

I think that it's not a question of a property right here. These are not entrepreneurs in any pure sense, but these are people who have entered into a very complex relationship with the Government and, like other vendors, we need to pay attention to them, we need to cultivate them if they are rare and unusual and have special qualities, but we need to drive a bargain from a public policy point of view.

Senator CRANSTON. Yes.

Ms. PERCY. As a tenant I would like to see rents stay affordable. I would like to see there be some incentives given to the owners so

that they would stay in this program because if the rents are not affordable and if tenants are forced to have tremendous increases two to three times a year, then they are going to be forced to become displaced.

And as a tenant living in a 221(d)(3) it would just work a hardship on the community. It's going to do several things. One of the things it's going to do when people become displaced is it's going to increase the crime rate. Let's face it, we are proud of the community that we live in and we don't want the crime rates to increase.

Yes, I feel there should be incentives for the owners, but by the same token, I believe that the rents should stay affordable for the tenants. I don't feel there should be two and three rent increases per year at the tenant's expense. Most people cannot afford it, and we look at a lot of factors for the owners, but we also look at lots of factors for the tenants.

Tenants in most of these apartment complexes have huge heating and lighting bills because of insulation not being proper and because of a lot of factors. So we have to look at the overall picture of tenants as well as owners. And certainly I want the best for the owners, but I also want the best for the tenants whom I represent.

Mr. EGAN. Mr. Chairman, I would like to take exception to the comment that was made earlier that owners are not entrepreneurs. I speak for a company that owns 450 assisted properties. We, the National Corporation for Housing Partnerships have advanced, while we have been the owner of those properties, about $80 million to keep those properties in operation.

On a day-to-day basis we have to make decisions in the absence of revenue flow, because of a lack of subsidy, deteriorating physical conditions, and a lack of rent increases whether we fix the roof, whether we replace certain vital components and where the money comes from.

So I take strong exception to the comment that we are not entrepreneurs. We are entrepreneurs on a day-to-day basis making risk and benefit judgments.

I would like to suggest, as a way to approach this issue, a couple of principles.

First of all, each deal is different, and each deal has to be approached differently. Marilyn used the term reunderwritten. I think that's exactly what needs to be done. Each property needs to be looked at in its total financial and physical context as to what its needs are so the residents can be well housed for as long a period of time as possible, possibly even beyond the current mortgage.

Second, rather than starting from the end of what is the original equity, I would suggest, as many have, starting from the end of what the rents could be and should be in an equitable situation. The section 8 standard is an excellent one to use. And if there are certain properties where the owner can demonstrate that there is significantly greater value than those rent levels, then those owners should be offered the right to prepay as they have under their current contract.

If the Government can afford to enter into a new partnership with that owner, and if that owner wishes to enter into that part-

nership at a revised rent level under a reunderwritten scenario, then that should occur.

I would also agree with Marilyn's comment earlier that if an exit tax proposal could be adopted similar to that proposed by Representative Rangel, many of the current investors in these properties who came in for tax benefits could be provided an opportunity to exit. I think at that point in time the Congress could extract and should extract as part of that bargain an extension on the use restrictions.

Senator CRANSTON. Mr. Burger.

Mr. BURGER. Mr. Chairman, I suppose I have never thought of myself as a vendor before, but perhaps I am. [Laughter.]

I thought we were entrepreneurs when we started 20 years ago, and my experience is much the same as Mr. Egan's is at this point in time. We are in the business of providing housing. We entered into a contract some 20 years ago that had a definitive period of time. It said what's going to happen at the end of that period of time, and in most cases we expected that that is what was going to happen.

I think that there are different types of properties out there at this point in time that should be considered. There are properties that are not affected that much by deep subsidies, such as section 8 tenant based subsidies. There are properties that could be prepaid without affecting the well being of the residents in some of those projects. There are other projects in areas where their highest and best use is exactly what they are now, and they would not effect a higher value at any other rate, and I think that those should not ever be prepaid probably. And there are some in the middle where, with some selection of incentives that have been put forth, you could in fact get the owners to voluntarily stay in and continue to provide the same kind of housing they have been doing for a period of time.

I think it's more than just a public issue question. It is in fact a legal question and it's a moral question. We have entered into contracts with the Government and we ought to be able to rely on those contracts that we have with the Government at this point.

Senator CRANSTON. Yes.

Ms. ROGERS. Senator, in looking at the position papers there was some emphasis on trying to get as much of this property into public ownership or nonprofit ownership as possible. I would like to take a position slightly different from that and say that we can't possibly solve this problem without the private sector, and that we have in Maryland at least some nonprofit owners who have not been entirely scrupulous in dealing with these properties.

So I don't think it matters whether you have a for-profit or a nonprofit owner. I think what you need to have as a result of anything that is done is a negotiation that locks the project into low income occupancy at minimum for the remaining life of the mortgage, and to do that you don't need necessarily what the market would pay, but you need at bare minimum what the owner will take as you grade incentives up somewhere between what the market ideally would pay and there is a number that most owners will live with that either stay in or transfer.

Senator CRANSTON. Yes.

Ms. ACHTENBERG. I think the point has to be emphasized that we have to have some kind of definitive legislative approach to this question, because what is happening now is that everybody is coming with their own preconceptions of what value is, and it really is stymieing deals and preventing them from happening.

I want to agree with the general framework that Marilyn and Sara have laid out in their paper in terms of developing a formula that reflects compensation related to initial investment as adjusted. I think it's really important to remember that we can't afford to be—and I would argue that we shouldn't be even if we could afford to be—as a government in the business of subsidizing values that derive from scarcity conditions. That is a situation that was not anticipated at the initial time these projects were developed, I think that there has to be a more reasonable approach that looks to a balance between owners' current expectations, which were not their original ones for sure, and the social purpose of the housing as it was originally designed.

Senator CRANSTON. Yes.

Mr. SIFLINGER. Mr. Chairman, I think we ought to be driven as a matter of public policy by the crisis that we're in, and it's not a transitory crisis. It has been with us for a long time, for as long as the Federal Government has been in housing, and you can assume that it's going to be with us for a longer time in the future.

The crisis I think is pointed out by the recent issue of the Joint Center for Housing Studies at Harvard. They point out that the supply of affordable housing is shrinking and continues to shrink.

As a matter of public policy, I don't believe that we can afford to lose any of these units, any of these units for low and moderate income use. Now, I, too, am intrigued by the concept promulgated by Marilyn Melkonian and Sara Johnson. I think perhaps the formula that they propose needs to be enhanced in some way to recognize the rights of owners, but in the final analysis the issue of the budget crisis and the shrinking supply of housing has got to drive us and to assure that we are protecting the tenants and go as far as we can to recognize the rights of the owners.

The other issue with regard to the formula is that this issue relates to judgment and real estate value judgment means you get five appraisers in a room and you will obtain seven opinions of value. I think we would be better off to ameliorate the downside risk of scandal that we have seen all too often, by agreeing to a formula methodology that reduces such judgment and protects the public from the kind of rip-offs that we have seen in these programs.

So I like the Melkonian idea in concept. It probably needs some work, but I think that kind of approach can be particularly helpful.

Senator CRANSTON. Let me ask you this question. Some owners have thousands of units. Do you think it would help if HUD could deal with such owners on the basis of their whole portfolios rather than project by project?

Bruce.

Mr. ROZET. I think Conrad and I probably share that situation. We have about 50,000 units. Unfortunately, units in those portfolios are owned by many different investors. Each group of investors

owns a single project, and we have about 350 or 400 partnerships. I think Conrad has about 450. So those are individual negotiations.

But if they were to deal collectively with the major owners, I think you could arrive at a program from HUD's point of view that each of those individual owners could then convey to their investors probably with a great deal of success.

As an example, and I realize it's beyond the scope of this committee, but if the 1039 provision were modified as proposed last year where there would be a tax forgiveness, and if all investors were given that opportunity of merely tax forgiveness for transfer of ownership, it is my guess that a very high percentage of those owners would accept that position without any discussion. I don't know whether Conrad would share that.

I might point out that the concept that permeates many of these proposals is a concept of negotiation, and the comments that are made about HUD's problems and who will conduct those negotiations are very difficult problems.

We can't rely on a process of negotiation to make a deal in this type of real estate transaction. I can see the difficulty in New York with the people that I know who own these projects. I'm afraid HUD doesn't have the people nor will they ever have the people to conduct those negotiations.

One recent notable purchase, for example, from one State that paid a lot of money was negotiated seemly favorable by the State, but I know because I talked to the owner that that same deal could have been negotiated for several million dollars less.

That's not a criticism of what was done. I'm merely saying the process of negotiation is very complex and difficult. That's why if one goes to a simplified formula of maintaining affordable rent for the tenants and it's presented to the investors, in answer to your question, if we present it to our investors and said this is an affordable rent that we must maintain as a matter of national policy, this has created a possible value of your property of "X" and therefore we would advise you to accept that, then I think we can do a good job in turning probably a majority of these projects into permanent low-income use.

But I think if we go to complex negotiations as to market values, I don't think we'll ever come to the concept of what is a fair return to put in the legislation. I think that's beyond the scope of any legislation.

Senator CRANSTON. Conrad, he asked if you agreed or disagreed.

Mr. EGAN. We agree to agree in this particular context, Senator. We have about 60,000 units. So between the two of us we have over 100,000 units that we control as general partners.

Each property is different as to its regulatory controls, as to its physical condition, its location, the types of residents it services, the level of subsidy. Equally importantly each property is in a separate syndication with a separate set of investors. There are some multiple syndications, but oftentimes there aren't more than two or three properties in a particular syndication. So you're really talking about individual negotiations in each situation.

However, we need a framework and that's what we are all trying to talk about here today. I think if a framework were structured such that tax forgiveness could be provided under certain circum-

stances, you would clear away a lot of the underbrush right away and be able to take care of many of the investor concerns.

Then if you could establish a value based upon section 8 rents and offer that deal to the owners, I think you would find that you would be able to deal with the current conditions of the properties that need to be recapitalized. These are properties that are 20 years old, that need physical repair, and that need to have their subsidy equations looked at. Some need more subsidy; and some frankly need less; and, in some cases, the residents should pay more, and in some cases, the residents should pay less. But each deal is going to have to be done differently.

Senator CRANSTON. Dale.

Mr. LANDON. The question it seems to me is one of who is going to bear the tax burden for providing this housing on an ongoing basis.

Mr. Rozet's assessment of value caps a value at what in some circumstances might be the true value but in many other circumstances, my project, for example, is far less than the true value. Therefore, I as an owner have been hit with a regressive tax if we take that posture—with a regressive tax for providing low-income housing.

I think everybody in this room is probably in agreement that this housing should be preserved and we should all work toward that goal, not just for 20 years, but forever. The problem is not going to go away, we have clearly demonstrated that.

But the question is should owners be required to pay a disproportionate share of the cost of providing this housing or is this a national problem? It strikes me that it is a national problem and should be a national tax. If we can spend $4 billion to develop a X-30 aircraft to go from here to San Francisco in an hour, it seems to me that we can spend the money that it takes to provide decent housing for our people and the Nation as a whole should be paying for it.

Senator CRANSTON. Larry Pressler.

OPENING COMMENTS OF SENATOR PRESSLER

Senator PRESSLER. I just want to throw in since we have been focusing on section 8 contracts and properties that in my home State of South Dakota we have far more rental properties assisted by FmHA and the problems are the same or similar. So if we can throw that in that would be very important to me.

Senator CRANSTON. Yes.

Senator PRESSLER. I would like to go back to the chairman's question of whether we should negotiate with the owners. He was speaking at that point of the National Housing Partnership perhaps and Associated Financial Corporation. They, like I am, are fiduciaries for a number of limited partners. I have about 1,200 limited partners, all of whom have a lawyer and all of whom have an opinion on what the value of this property is and what they want to get out of it.

Somewhere along the line we have to come up with a package that is going to dissuade these people that every project in the middle of the desert in California is a condominium project. Now I

think we can do that, but I think Mr. Rozet was correct in saying that we've got to have the tools to go back to these partners and say here is the situation and here are the kinds of things that we can live with. As a fiduciary, I cannot go out there without those tools.

Senator D'AMATO. Does anybody have any answer to Senator Pressler's comment?

Mr. EDSON. If I could respond to the Senator. In ELIHPA, which is your Emergency Low Income Housing Preservation Act, it treated Farmers Home differently, and the bottom line is you had a fair market value buyout. You established the principle that the owner was entitled to the fair market value return.

What is good for the countryside is good for the whole country. In other words, the principle of a fair market return to the owner should be embodied in legislation. To put it in a larger context, the guiding principles of our housing legislation have been the tenants should only pay a given percentage of their income, and I totally agree with Ms. Percy in what she said. On the other hand, the owner is entitled to the fair market rent for renting his or her property for this use. How is that gap bridged? We have had a way of doing it since 1974, and it's called section 8 assistance, and that is the principle to espouse. As I say, the concept is embodied in Farmers Home and it should be made applicable to all programs.

Ms. JOHNSON. Many industry members have suggested that a reasonable compromise is increasing the rents in the 221(d)(3) and 236 projects up to the section 8 fair market rent, that this might not permit an owner to access full fair market value, but that it's a reasonable compromise.

I just want to put a cost figure on that proposal. In the National Housing Trust testimony we have a chart that is attached that shows the cost of that solution, and it is $12 billion over a 20-year term to provide a rent increase, and we are talking about a transfer of wealth from tenants and taxpayers to perhaps as few as a thousand owners of most of the stock in that amount.

If that is the determination of what is fair under the circumstances, all well and good, but I think there should be a understanding of the cost associated with the proposal.

Mr. EGAN. I would like to follow up on Sara's comment to say that the National Low Income Housing Preservation Commission estimated the costs of doing nothing about the problem in terms of defaults and loss of affordable housing plus vouchers that would have to be given to many of the residents at $17 billion.

Senator D'AMATO. Larry.

Mr. SIMONS. Senator, maybe I look at this thing a little differently. I have a number of cases which I am familiar with where above 50 percent of median income the owners are not looking for the full fair market rent at that time. They are looking for something which would be affordable to the tenants, and I'm talking to 236's as well as BMIR's. There is no additional Government subsidy except for the very low income tenants, and that's something we have to face and we have to take that responsibility, and I think it's consistent with the way Congress has legislated section 8.

What I am troubled by is that we are getting the cart out in front of the horse. I think if we took an aggressive attitude as far

as what rents could be that are affordable, you will find many cases where these will work out, and especially if the critical date in the act is moved up a few years because right now you have to wait until the last year. Under existing law you know what the market circumstance is, and the owner goes out and he knows exactly what he can do in the market.

If you move the decision date up a few years so that the owner would have to make a decision before he knew what that actual market would be, you would most likely have a better negotiating position and the owner would be anxious to make a commitment to low income use since if you use an affordability standard in most 236's and in most BMIR's you are getting substantial rent increases phased in which is something that the owner most likely would be happy to have, a bird in the hand rather than waiting for the bird in the bush.

Senator D'AMATO. Yes.

Ms. YOUMANS. I would like to say that if anything, the date at which we are pegging all of this should be set at sometime in the past. If you set a date at some point in the future, I think that owners will select tenants with incomes that are more toward the upper end than toward the lower end.

We proposed in our written statement that the date be set at January 1, 1987, and we also proposed that 50 percent of the units in these projects be reserved for people with incomes below 50 percent. That should be the affordability test.

Many people will balk at this figure, but 50 percent of median income is not a welfare rent and in many cities it is very high. In 1986, in San Francisco and Boston 50 percent of the median was $18,000.

As Mr. Siflinger said, we are in a crisis, and I think that these units should be preserved, as many as possible, for those with the lowest incomes possible. Once you decide that, you can determine what the fair market value is and what the fair rate of return is.

I will go back to what I said in the beginning. Rather than pay owners to stay in for another certain number of years, why not figure out what it would cost—I think it would be cheaper—to transfer these properties with a capital grant—like Farmers Home does—to qualified nonprofits? Some may think that nonprofits don't know what they are doing, as Ms. Rogers said. Some don't. There is also a need for technical assistance to help facilitate this.

But once you get these properties into the hands of organizations and/or tenant bodies that are interested in preserving them for the long term, you don't have to keep paying the inflated market rents. You could use the money that you save from the vouchers that have been appropriated for this and the recaptured section 236 interest reduction payments to help finance these capital grants. We should not be turning these things over and over again.

Senator D'AMATO. Does anybody want to comment on that?

Mr. GRADY. Senator, I would like to jump in there also. I believe that there is no question that it would be proper to approach Mr. Egan or Mr. Rozet and then try to make a deal on a substantial portion of their portfolio and let them in turn delegate to go and see their investors.

And although I don't have the size of portfolio which they have, I have certainly a fairly large and extensive portfolio ranging from a very, very valuable project in the San Diego area to some others which are not that valuable.

I believe that it is important in order to protect the interest of the Government that we deal with this on a project-by-project basis because in some cases it can cost absolutely nothing to the Government to continue to operate the projects for the tenants which now occupy them.

I mean in some cases it is going to cost some money, and to try to average out because there are various investors is not going to really do it and every project will have to be looked at individually. It's a very hard task. Maybe it is possible to deal with persons who represent a variety of projects and delegate to them to come and make some kind of a deal, but the deal will be quite different depending on where the project is located and the nature of the project.

Ms. ROGERS. Senator, if I might, I agree with Mr. Grady. I think the least cost solution to the Federal Government is a negotiated solution on a case-by-case basis because of the variations in projects that are out there.

However, that raises the awful specter of where will the capacity come from to do the negotiating because we wouldn't want to end up in a situation of further paralysis.

Today I am representing 6 States in the Northeast who have been working on this issue for some time, and most of us would be willing to do the reunderwriting that Mr. Egan referred to if we had a reliable, predictable package of Federal tools behind us so that we could cut the least cost deal for the Federal Government.

We have expertise and we are out there doing things now, but we don't want to be on the front line and negotiate deals and then find that the resources from the Federal Government are not there to actually close on the solutions that we come up with.

Mr. KOELEMIJ. Senator, I am very impressed by the numbers that are being thrown around of the size of portfolios. I happen to be one who years ago, when the program started, built some projects and I own them and I have managed them all these years, and I don't want a deal. I just want you to continue to give me what I had when I started the program.

When the tax laws were changed in 1986 you hurt me substantially, because I am an entrepreneur I started to look for what else can I do to retain the value I expected when I committed myself to build these projects. It was a 10-percent downpayment and the equity investment was reasonable, and some of that came through the mortgage, but I committed myself to operate them well and to live with the restrictions and the controls.

Now what you need to do is, you need to reestablish some of these tax benefits that we had in some way, shape or form, or you need to give me some other method by which my equity investment or my return on my investment is not hurt as it is hurt today.

I don't want to opt out and I don't want to change anything and I want to keep the tenants, but you need to do something to make it possible for me to continue to operate these projects.

Senator D'AMATO. Let me ask you this if I might. If we did nothing, what would be your situation? That's a question I'm going to ask, which the staff asked. If Congress does nothing and, by the way, I think there is a good chance that that's exactly what's going to happen, I don't know if the administration and the Congress has got the capacity to come together in a manner which will deal with the variety of complexities, and the complexities as it relates to this program.

I haven't seen us demonstrate that capacity to date, and we are having a difficult time even building a consensus, notwithstanding that we have the Majority Leader himself, Senator Danforth on the Tax Committee, and others who recognized a simple extension, and I think they should permanitize the low-income tax credit.

If we can't get that done, and I see Senator Bryan here, and let me say, Senator, at any time if you have any question, please raise it, because the format of this is to get a more free-flowing kind of forum.

So that's just an observation, and I hope I'm not pouring cold water on anybody's parade. Probably some of you have your own thinking. You've been dealing with this business for many, many more years than I have been here, and certainly have greater expertise.

Do you really think we are going to come up with a legislative solution?

Well, let's get back to you. What happens if we don't do anything, and I would like some people to respond.

Mr. SIMONS. It expires and there is no more restriction.

Senator D'AMATO. If we don't get a legislative solution to this, what would happen in your particular case and what are the consequences?

Mr. KOELEMIJ. Of the three projects that I have, one absolutely would convert. I would opt out. It's a 236 and I would pay off the mortgage and I would convert because it's in a good location and it's suitable for other uses.

Another one potentially could be converted, but we haven't looked at it, while the 3rd one is less subject to conversion, and I would probably try to do whatever I can to work with either a nonprofit sponsor or the local housing authority to retain it in the service for low-income families.

Senator D'AMATO. So there would definitely be in two of the projects, or certainly one, a major dislocation.

Mr. KOELEMIJ. Yes, sir.

Mr. EGAN. Senator, let me follow up on that, too. As I mentioned earlier, the National Low-Income Housing Preservation Commission studied exactly that question. Our portfolio of roughly 450 subsidized properties, 300 of which fall into the older subsidized category, was also reviewed at the same time.

Let's just take a look at the roughly two-thirds of a million, 660,000 or so, units that fall into the older subsidized category. If nothing were done, that is if the Government did not intervene in any way whatsoever, about 40 percent of those units would be prepaid and would be lost to the affordable portfolio.

About 40 percent of them would continue to deteriorate and suffer poor cash flow to the point where they would go into default

and HUD would have to pay claims out of their insurance fund. Then they could go into foreclosure at that time and presumably be acquired by the Department.

The remaining 20 percent would remain pretty much the way they are.

The costs of providing vouchers to those tenants whose units are taken out of the affordable inventory and the cost to the FHA insurance fund which are the consequences of doing nothing is $17 billion.

Mr. SIMONS. Just to focus on the prepayment issue, Senator, I think the National Low-Income Preservation Commission looking at just those that they felt might be eligible for prepayment felt that in that category there would most likely be 60 to 70 percent of the projects that would prepay, that a high percentage would prepay, a much higher percentage than was expected when we originally looked at it.

Senator D'AMATO. Senator Bryan, do you have any question that you would like to raise at this point?

Senator BRYAN. Not at this point. Thank you.

Senator D'AMATO. I raised the point about the chances of passage of some legislation dealing with this, and some of you have been dealing in these areas for a long time.

Bruce, what do you think?

Mr. ROZET. I would mirror Conrad's position, but rather than go to the statistics, let me point out just what I think are business facts of life.

This issue has received a lot of national attention in the press. I think we even made a mistake in this legislation when we suggested that HUD contact all the owners and tell them that they had a right to prepay. Most of the owners are sleeping giants and they don't really know that they have that right or a good number of them don't. So we really did a good job. We notified everybody here that you have a right to prepay, which in effect created listings for real estate brokers all over the United States who went back and said, "hey, guess what, you have a right to prepay your project and we'll sell it to somebody."

I suggest the practical implications of what we do here need to be looked at in the marketplace because there will be press on this and there will be plenty of brokers picking this one up.

But consider again that most of the owners of these properties are in fact limited partners who invested through the brokerage community or through syndication. As these owners, these individuals who invested begin to learn that this opportunity is available to them, they will put the pressure on us as general partners and no matter what our personal motivations are and our desire to maintain this housing as low-income, those investors will take a position that it is their legal right to maximize their position and they will be all over us with hobnail boots saying "you are a fiduciary and your obligation is to get for us the maximum dollar."

If that occurs, the cost will skyrocket. That's why I think it is important that we get legislation and the tools to work with so that we can in fact go back and negotiate the best deal consistent with public policy and to maintain the housing for the tenants who now live there. That should be the overriding objective, the preservation

of the housing for the people that live there today. We should bring that cost in at the least cost to the Government, in my opinion.

Senator D'AMATO. If I might make an observation, and again this comes from staff. I don't want to take the credit, or the blame for it. [Laughter.]

But I really think that we should be focusing in on the Tax Committee, and I will give you an analysis of those things that have been pointed out to me. There is absolutely no inclination on the part of the Tax Committee to undertake anything in this area. I believe that the only force as it relates to dealing with this problem in the House of Representatives is a legislative initiative undertaken by Congressman Rangel. Absent that, there is nothing going on there, and I know of no undertaking of a similar kind in the Senate on the Finance Committee.

So I'm kind of giving you a little heads up, which you're probably aware of, and you may want to galvanize because sometimes it takes more than one. You know, these committees are rather jealous of their prerogatives. How dare you introduce this, you're not even a member of the committee, and what do you mean you're going to offer an amendment on such-and-such. Pride of authorship is not unique to the Banking Committee, although we are much more tolerant. Right, Mr. Chairman? [Laughter.]

But some committees are very, very zealous of their prerogatives, and I would just submit for your consideration, the groups here and owners, tenant groups, et cetera, that this matter begin to be one that you share and use the political process. I don't want to say the bad word, but you had better begin lobbying for this effort. It seems to me that has become almost a conspiratorial thing today in our atmosphere, but I would begin to use that which is guaranteed to you to seek access to your Representatives and particularly those who are on those committees.

You want to make an observation.

Ms. TORPY. I just wanted to respond to your question of what would happen in our town if we all did nothing. The project that our nonprofit is working with has 336 families living in it. Three-quarters of them are below median income, and I might add also that 80 percent of those families have working adults in there, and 80 percent of that group has two working adults. But they could not afford market housing in our community.

Thus this housing, this 221(d)(3) project is a resource to us, but if it's allowed to expire in August of this year, it's a disaster to us. These families will not find housing in our market which has less than a 3-percent vacancy rate. Forty-three percent of those families are below 50 percent median income and need substantial subsidy.

So I think that it's very, very important that there be a solution. There is as high a cost to dealing with homelessness I think from a matter of public policy as there is to saving this housing. I think it will be less expensive to save this housing than to build new or to find other solutions.

I would also like to say that it's important, given what we have heard today about the dilemma on the public side of rewarding the private sector and entrepreneurship that we might want to look at the option of a nonprofit sector of housing delivery that can fulfill this role, complement this role and possibly being more in tune

with the public because there is no need at certain points to take profit.

Our nonprofit has exactly the same goals as the Preservation Act, not to displace the families and to maintain affordability. We have set a rent that is below the market rent in the community, and so subsidizing the families to that rent is going to cost the public less.

I might add with that, too, that the families between 60 percent and 80 percent median income, many of them do need subsidy. Our rent, even though it's below the market rent, is above 30 percent of their income, and I don't think it's fair to ask the families who are below median income to subsidize our housing programs in the lowest income. I think we should look elsewhere for that subsidy.

So I think it's very important that we do something, and I would recommend that we look at saving dollars in the future by putting more and more of this housing stock into nonprofit hands which shares your purpose of preserving affordability forever.

I think also local nonprofits have the ability to raise the kind of State and local resources that the Federal Government needs to match these scarce resources to achieve it's purpose.

Senator BRYAN. Senator, may I ask a question. I came in late, and if this has been addressed previously, I'll be happy to examine the record that is prepared for us, but assuming the basic premise that we don't want to lose any of this affordable housing inventory that we have, is there a consensus among you in terms of what policy options the Congress is out to pursue?

Assuming a more optimistic scenario than Senator D'Amato has pointed out, and I don't mean to take exception to him at all, but again in a perfect world, in an ideal situation what would you have us do in terms of congressional response to this problem?

Ms. TORPY. I think the congressional response, and we have all said here that the Preservation Act was a good start, but extending the goals of that beyond next year so that there is a clear direction that preservation is important. We need long-term subsidies for the families in the housing and we need capital grants in order to maintain that housing, to repair it and to make sure it stands up in its useful life. We need an Office of Preservation at HUD that has the power and the resources to put these programs into effect, and we need some flexibility with the existing programs so that they can work together in this new situation. A lot of this needs to be done legislatively.

We also do need, although it's not the purview of this committee, some changes in the tax law that would encourage owners to sell to nonprofits if their capital gains could be forgiven. That would be of great benefit.

Senator BRYAN. Does the legislation which the chairman and Senator D'Amato have authored and of which I am proud to be a cosponsor, is that moving in the right direction?

Ms. TORPY. It is moving in the right direction——

Mr. SIMONS. Isn't that the blank page? [Laughter.]

Senator CRANSTON. Can I go on to an issue relating to incentives. We are told that most owners of this housing would probably retain the low-income use of the property if we were able to come up with the right incentives.

Senator D'AMATO. Mr. Chairman, if I might just respond briefly to our colleague, we did not attempt to address this important area of concern in our bill because it is so contentious, and because notwithstanding 2 to 3 years of work, we have not been able to develop any kind of a consensus that we thought we could get the kind of support that we need. That would be most contentious and defeat the entire bill.

So our thought in the hearings, and the purpose for us was to deal with this separately this fall as a free-standing piece of legislation rather than to introduce this in the comprehensive bill which would I think doom it, and the bill to certain failure.

So, if I might, that's why I think Mr. Simons said that's the blank page, and we did not choose to address it in this forum.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much.

On the matter of incentives, what incentives authorized in the 1987 act or elsewhere have proven to be most useful, what refinements or new incentives, if any, need to be explored either in this committee or in the Finance Committee to make prepayment solution work?

Any suggestions on that score?

Yes.

Mr. GRADY. Well, Senator, I hate to suggest some of these after the remarks of Senator D'Amato toward the tax bill, but I think that in order to make the most of the incentives that are already available or of any new incentives that have been talked about around this table this morning, it is necessary to revisit the 1986 Tax Act and make some substantial changes in the 1986 Tax Act. I think that changes in the Tax Act are the linchpin to make anything else which we have talked about work.

I think the changes should be made which would allow our owner who has entered into an agreement to extend the lock-in period for the balance of the mortgage term to receive benefits similar to those granted to an owner who has just purchased a project. Additionally, a transfer to a qualified nonprofit investor who will agree to operate the project for the balance of the project term should be a nontaxable event. Without the revisions of the Tax Act, we are going to have great difficulty making anything work.

Mr. LANDON. Senator, if I could, I think what we are talking about here is a bundle of rights or a bundle of incentives. There are different owners, as has been pointed out earlier, that have different motivations and different bases, and some are maybe tax driven and some are cash driven.

The bottom line is that it's going to cost money to do this, and whether it's in the form of direct cash subsidy, whether it's in the form of forgiveness of capital gains tax or some other tax incentives, it costs money.

It's very disturbing to hear Senator D'Amato state a fear that nothing will happen, and I would take that one step further, if nothing happens, the easiest way out then is just to extend the current moratorium which, in my opinion, would be a disaster.

What we need is some direction that says the Congress and the administration are willing to attach a dollar amount to solve this national problem and do it.

Senator CRANSTON. Let me say that I think what Senator D'Amato was doing was suggesting that members of the Finance Committee have to hear from those of you who are concerned about this because there hasn't been the focus on that committee, they have too much else to contend with, as there has been here.

So heed that advice from him.

Yes, down at the corner.

Mr. EDSON. I think the Senator from New York was giving us a good dose of reality, however, in two respects.

First, there is not a great inclination of the members of the Finance Committee to really get into it, and certainly we should lobby them, but I'm not sure how that would come out.

Second, I think we are on the wrong track when we want to go back to utilizing passive losses to keep owners from paying tax like under the old system. I think that that is a fairly discredited notion within the tax writing committees and the Congress as a whole.

I don't want to analogize myself say to a reformed alcoholic, but as far as relying on tax writeoffs against ordinary income as our principal incentive in a way I am sort of reformed. I think that it is a very, very difficult path and that really the thoughtful comprehensive solution has to come out of this room and out of the House Banking Committee rather than in the tax committees. It's more reality than wish, but I think we have to live in the world as it exists.

Senator CRANSTON. Yes.

Ms. JOHNSON. I just wanted to point out that the low-income housing tax credit has been used in some of these prepayment projects to transition projects to new ownership, and I'm very concerned to see provisions in the pending legislation to extend the credit that are antithetical to preservation.

For example, the requirement of a minimum level of rehabilitation as a requirement for getting the acquisition tax credit. Many of these prepayment eligible projects don't need that level of repair, and basically by imposing that requirement you're saying that the credit is off limits as a preservation tool.

So I think we have to watch very carefully the tax credit legislation as it goes through the process because there are some provisions that perhaps inadvertently hurt the preservation effort.

Senator CRANSTON. Yes.

Ms. ROGERS. Senator, there is a gradation of incentives. There are a number of things that HUD could do immediately administratively with regulatory change that would begin to bring relief. Just routinely permitting people to access reserve funds and access income as well as permitting drift upward and return on income are things that HUD could do now.

To go beyond that and turn to Congress and say what do you need to do, you need to make an earthshakingly clear policy statement that the Congress intends for HUD to use its tools and what tools Congress provides in order to have housing preserved because HUD is presently very schizophrenic and is in a conflict with OMB

about whether it's in the best interest of the Federal Government to let things opt out or to keep them in. So national policy is not clear in this area.

If you act, then I think probably a combination of current tools. A special tax credit allocation dedicated exclusively to preservation, some volume cap for tax exempt financing over and above what is presently available for new production and, finally, some capital gains relief for individuals who opt to sell but are willing to lock their projects in over the long term are the three most obvious new avenues that you have to pursue for better incentives.

Senator CRANSTON. How much do you think individual States and localities should be required to contribute to project workouts? Yes.

Mr. SIFLINGER. Senator, I am from the Massachusetts Housing Finance Agency, and those of us at the State level in Massachusetts have already stepped forward. We have looked at some deals that are pending with HUD and there are resources available to assist.

We have offered State resources to supplement the HUD resources that may be available in order to protect the tenants. The basic issue we are trying to address is to recognize the rights of the owners, and protect the tenants. We are trying to strike that balance. However, it's hard to say at this point whether one can develop some kind of matching mechanism at the State level in a majority of the States.

There are some States that feel absolutely committed and will provide resources to assist in this area. We are, and I'll use this word, we are terrorized by the possibility of prepayment. In my State of Massachusetts there are 29,000 units that are at risk in a situation in which there is little or no vacancy rate, in which home prices have escalated dramatically over the last several years. There are 11,000 units in the MHFA portfolio and 18,000 units of FHA assisted housing. They are all at risk and we feel we have no choice but to provide assistance where we can afford to do so; however, we must have leadership at the Federal level.

Senator CRANSTON. Yes.

Mr. SIMONS. Senator, I respectfully disagree with Mr. Siflinger, although they do a marvelous job in the State of Massachusetts.

As you look at this problem, it would be nice to have the States come in and be part of the solution. On the other hand, at that point you are now creating an unequal playing field, and I think that it is the Federal Government's role basically to create the thresholds at which the preservation will take place.

If States want to go further, let them take their resources and go further, but I think the Federal Government has a responsibility for being certain that certain thresholds are met.

Senator CRANSTON. Yes.

Ms. TORPY. I would just like to describe what our State has done. Prior to 1986 Vermont didn't spend $1 of its own public housing. In the face of this crisis, the State created new resources and targeted them to preservation first and the creation of new affordable housing second.

One thing it created was the Housing Trust Fund which has dedicated $3 million to our project alone. Now that's a big State in-

vestment. The State also pooled the tax credits in an equity fund that offers a lower but certain return to investors and targeted them to nonprofit development with a priority for the preservation of housing. These dollars are also coming into our project as private investment.

I think that any dollars that the Federal Government provides through HUD could have an incentive for State and local participation for matching dollars to leverage State dollars where that hasn't been done, and I think more States would get involved if such a thing were possible.

Senator CRANSTON. Some of you have argued that a basic thrust of the national policy and prepayment should be to transfer the ownership of the housing over to tenant organizations, other nonprofit organizations or public entities.

If public policy concentrated on transferring ownership of this housing to nonprofit organizations and public agencies, what would be the benefits, what would be the drawbacks and what would be the most effective incentives to use if we attempted that, and by how much would the large tax liabilities of current owners drive up the costs of these transfers?

Yes.

Ms. ACHTENBERG. As an advocate of that kind of an approach, let me say I think the benefits have to be looked at in terms of cost savings ultimately because, as has been pointed out here earlier, if all we are doing with preservation legislation is revving up and revising and restructuring an existing or a different private ownership arrangement which is going to demand being bought out again at some new market value in 20 years, we are just perpetuating the same problem that we started 20 years ago.

I think that where there is capacity for nonprofit and tenant ownership, and I come from a State where that capacity is very strong, and there are certainly States where it is not, but the point is that the legislation and its incentives should be designed to advantage and give preferential treatment to that kind of ownership solution where it is possible to make it happen.

I think there are a number of ways that that can be done, which the current legislation does not accomplish. It gives rhetorical recognition to the goal of tenant and nonprofit ownership, but when you look at the structure of the incentives, they really are primarily geared toward keeping existing owners in place.

I think what we need to promote the possibility of nonprofit and tenant ownership to a larger extent is a preferential allocation of subsidies. We have no setasides right now at all for preservation, unless maybe you could construe the flexible subsidy capital improvements program as a kind of a setaside. The point needs to be made very clearly that we now have no funding setasides for preservation incentives at all.

There ought to be those setasides, and within those I would argue there should be preferential allocation for certain kinds of subsidies like project based section 8, like flexible subsidy and so on given to ownership arrangements which commit to preserving the lower income use well beyond the term of the existing mortgage and hopefully in perpetuity, which would be by and large nonprofit sponsors.

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I think the other incentive that we need, as has been discussed here, is on the tax side, forgiveness of capital gains where the property is being transferred for perpetual low-income use by nonprofit ownership. Again, I would prefer some kind of approach that gave preferred treatment where the transfer was taking place to a nonprofit than where the purpose of the transfer was simply to extend low-income use temporarily by an existing private owner.

Third, let me just suggest this. I think that another way we can advantage nonprofits in the structure of the legislation is to have an extended window of coverage under the act for properties being sold to nonprofits. In other words, if it's a 3-year window for everybody, it ought to be a 5-year window to bring more projects in where there is a proposed sale to a nonprofit.

Right now there are nonprofits anxious to buy properties that are not inside the window of title II, and their owners are willing to sell them to nonprofits as well, but there are no resources available because they are not within the jurisdiction of the legislation.

Senator CRANSTON. Bruce.

Mr. ROZET. Let me start by saying that I approve of the idea of trying to move properties into the hands of more interested parties who are concerned with keeping them low-income, but I have to defend private ownership to a point. There is nothing inherent in the concept of private ownership that says that they only have to be kept low income for 20 years. To the extent that the incentives are given, they could be given on the condition that the property remain low income for the rest of its useful life. That doesn't negate their ownership by private entities.

Second, I think it's important that we differentiate between private ownership in the hands of community nonprofits, of which there may be very good ones and there are certainly some in Massachusetts, and ownership by tenants.

I applaud Secretary Kemp's attempt of converting to ownership by tenants, and I think that approach deserves special merit, particularly where there are some resources to help develop and train the tenants in the concepts of ownership. Perhaps the role of the nonprofit should be to help the tenants become responsible owners of the housing over some period of time. I'm all for the idea of converting to tenant ownership.

I think, however, the tax implications raised are important. I have been favorable, as you know, Mr. Chairman, for some 4 years to try to eliminate the gain on sale as a way of preserving housing.

I agree with Senator D'Amato that the outlook for that legislation is very dismal. Therefore, I think we have to work with what we have. I think we can give ownership to the tenants if we can use 501(c)(3) bond financing and allow for refinancing on that basis at favorable rates.

But the real issues, if I may digress a second, is that we could start this process and we need very little. We just need the ability to sit down with somebody and start negotiating. I think if we had that ability today—as Mr. Egan says, "let's make a deal"—I think that we could get the process going based on many of the incentives we now have.

HUD has established some guidelines for rent restructuring or reunderwriting, and if somebody would just give impetus to the

idea of sitting down and negotiating and making a deal, I think you would begin to see this preservation effort take hold, take root and start to grow. Then as and when problems arise we can address the need for additional legislative activity.

Our biggest problem today is not that we don't know how to do it and not that we can't create ownership by tenants or ownership by investors who will keep it permanently low income, but we have no one to talk to. If we could start talking to somebody who had the authority to proceed with a program, I would guess that the bulk of the units threatened today would be converted to permanent use as low-income housing within 2 years.

Mr. SIMONS. Mr. Chairman, one other point. I would like to talk about public entities and not have you forget that there are Public Housing Authorities out there, very competent ones and very good ones, who would be willing to acquire some of these projects.

On top of that, once the Public Housing Authority acquires a project, they go into a different real estate tax structure usually than these projects are under, and it's a means of saving money in the operation of the project.

They also have the power to issue tax exempt financing, and I think, as I said in my paper, a hard look should be taken at the 236 enabling legislation to see what changes are necessary there in order to facilitate the movement of the 236's not only to nonprofit but public entities and to continue them in the low and moderate income fashion.

Senator CRANSTON. On the matter that Bruce brought up, and it would be nice to be able to negotiate for somebody, most of you seem to agree that the prepayment problem should be resolved on a project-by-project basis rather than the process in the 1987 Housing Act that requires HUD approval of a project-by-project plan of action. Some of you would prefer a process in which owner participation would be voluntary.

So the questions are I think how capable is government at the Federal, State or local level to carry out the negotiations that would be required for successful project-by-project solutions, how could the creation of an Office of Affordable Housing Preservation enable HUD to put together a team with the legal and financial expertise necessary to negotiate these workouts and would that work out, how could the process established in 1987 Housing Act be improved to minimize rank in transaction costs and to serve the best interests of owners, tenants and the communities in which these developments are located?

Yes.

Ms. ROGERS. If I might start, Senator. My personal view is that the delegation of negotiating should go to the lowest level of government that demonstrates the capacity to negotiate responsibly on behalf of the Federal Government. So in some cases you will be talking States, in some cases you will be talking cities and in some cases there is no one but HUD to negotiate these deals because the local capacity is nonexistent.

In the context of a State plan that was adopted, approved by HUD and with the availability of reliable tools so that HUD's role would be simply to say yes, this is a tough deal cut within the Federal parameters of how to use the tools, States and local govern-

ments would be willing to step into the breach and help get this job done, and where they have the capacity they should do it and not HUD simply to spread the burden a certain amount.

But we are terrified, and somebody used that word earlier, but we are terrified of getting involved in Maryland and doing this, and we do have the capacity to do it, unless we know that the Federal resources are there to back the deals that we negotiate.

We spend $55 million a year in State money on various kinds of housing production loans, and we have recently enacted a package of disincentives so that in the event of Federal abdication, which was pointed out by Senator D'Amato as a possibility, we can't at least have orderly transition in Maryland, and in the paper we submitted we suggested that you might want to look at some of those disincentives as well.

Ms. MELKONIAN. Well, I think that there is not going to be any substitution for professionalizing HUD again. I mean we have to face the fact that the agency has been denigrated and in many cases its professional skills destroyed over the last 8 years, and that simply is an intolerable state of affairs.

I think that we have a new Secretary who has the political will, perhaps, to reinvigorate the mission of the Department, and that must, if sincerely carried out, extend to rebuilding the professional talent that has to exist at the Federal level to do anything in the field of housing and community development in an effective way.

And what more natural target for that effort than to preserve what we have already built and to regain the underwriting skills and to regain the contacts with State and local agencies and to reinvigorate the "new federalism" in the housing area which requires a strong Federal partner.

I think we have to recognize the fact that the staff at HUD has been cut from 16,000 people to 11,000 people and we have to reach out and bring those skills back into the Federal arena.

Mr. EGAN. Mr. Chairman, as a former HUD official I can say that HUD is as responsive and as professional as a Congress wants it to be and as the Executive Office permits it to be. I think we now have the will within Congress, and I think we have the will at the executive level in the White House and also in the Secretary's office at HUD to do what needs to be done.

I agree with Jacqueline Rogers that the key is providing the resources both in terms of funding for either staff positions or other technical specialists that need to be brought on board and, most importantly, for funding the incentives.

If Congress were to establish a specific timetable, it would point out clearly what the priorities are. HUD would then, together with, where appropriate, State and local agencies, be able to organize around that timetable, to mobilize their resources and to get the job done.

But HUD can be as responsive and as productive and as professional as, frankly, Congress wants it to be.

Senator CRANSTON. Eugene.

Mr. BURGER. Speaking as one who has been dealing with HUD for some 28 years relative to negotiations of all kinds, I would like to say that we still have people alive and well out in the regions

and out in the areas. They have been there for years and years and years. So most of them know how to do their job.

Mr. Egan came from one of the regions I work in, as did Sue over here. Those people can do their job out there without the necessity perhaps of establishing a whole new department to do that.

What I would suggest, however, is that if we are talking about a preservation effort and we're talking about some sort of secondary financing, i.e., the 241(f) loan, perhaps we should look at the way that it is processed. It's processed under the Underwriting Department at this point or under Production; it takes a long time and there are different kinds of criteria that are added to that particular process.

We have been dealing for a number of years with MIO plans. Millions of dollars worth of rehab work has been done on projects quickly and efficiently through that process without having to go back through and rewrite everything under the Underwriting Department.

I would prefer to look at it from that standpoint of how you process it and not create another whole department that has to get up and running and figure out what they are going to do with their staffing.

Senator CRANSTON. I have to go to a phone call, and I'm going to ask Don Campbell to carry on briefly so we don't just grind to a halt and I'll be right back.

Mr. CAMPBELL. Larry.

Mr. YATES. I will fulfill our role of being contentious here by disagreeing with the gentleman next to me. I think we do need a new office. The name for that office which we are hearing at HUD yesterday as a possibility or as an option was the Office of Preservation and Tenant Assistance which I think gives a very strong and appropriate direction to that office.

I think when we talk about a capacity to negotiate deals, if we don't focus on the capacity of the residents to negotiate those deals, we are missing really the whole ball game. The residents are the individuals period, and the only individuals—though I represent and worked with nonprofit and feel there is a role for public agencies—the residents are the individuals who are on the line and who have the motivation to make sure that negotiation is fulfilled and meets the goal that everybody is at least paying lip service to here.

They are the real sleeping giant, to use a phrase that Mr. Rozet used earlier, and they need to be given the capacity or assisted to develop the capacity, they need technical assistance and money needs to be spent so that tenants can be involved, residents can be involved in this process.

I think HUD probably is the most appropriate place for that to spring from, though obviously there is a great role for local, State and nonprofit groups.

And certainly I would echo what Mr. Egan said about the need for funding. We cannot build HUD back up without spending some money to do that, and I think that HUD at this point wants to be built back up. So I think it can be done now.

Mr. CAMPBELL. Marvin.

Mr. SIFLINGER. Well, Don, as you know, and as some of you have been my colleagues, I spent 25 years at HUD beginning at a GS–7

and the last 7 years at HUD as the Director of the Boston Office. I know the organization well, and I have seen it in its good times, and there have been good times under both Republican and Democratic administrations.

I feel that placing this kind of responsibility that involves, in effect, project retailing at HUD and even supplemented with the capabilities and capacities of many States represents a very, very difficult burden for negotiators at the State, local and at HUD level.

I don't know whether or not it is possible to place this kind of retailing responsibility on the public bodies at the three levels of government and get what we want out of this process.

The best approach given the limited capacities that I think we're able to get would be for the legislation to create a framework—a formula that reduces the level of discretionary decisionmaking and provides for some flexibility for the negotiators at the three levels of government, but I think a free-forming retailing approach to this problem invites very, very serious problems that we touched on earlier.

Mr. CAMPBELL. Chuck, you had your hand up.

Mr. EDSON. Thank you, Senator Campbell. [Laughter.]

Marvin almost took the words out of my mouth. I disagree with the premise of this question, like I have of so many questions, that the dealing does have to be on a project-by-project basis. I know when I met earlier with your staff colleagues they kept emphasizing this individual negotiation approach. I tried to say let's have a conceptual framework, on a universal basis as to what an owner should be entitled to.

That then obviates the risk of negotiations, such as lack of staff capability, and not to denigrate the good people at HUD, but it just puts them in an environment that they are not quite used to, as Marvin well pointed out. Second, it does away with the possible charges, right or wrong, of favoritism. So I really disagree with the premise of the project-by-project approach.

Let me just obliquely comment on something that my able State Secretary in Maryland said, Ms. Rogers, that Maryland passed a State law—a somewhat onerous State law—to handle this problem in the vacuum of no Federal legislation.

If we do get Federal legislation after this very arduous process, I hope that such law would preempt State law that is more rigorous or puts more rigorous requirements on the owner or, if not, we are wasting our time in this exercise.

Mr. CAMPBELL. Dale Landon.

Mr. LANDON. I would like to expand on Mr. Edson's comment. I don't understand the concept of negotiation in this context. I always thought negotiation was when you had two willing parties sitting down to strike a deal about something. I'm not sure we have willing parties on either side of the table in this context.

It strikes me that there is a level of inducement which will cause owners to stay in the program, and they become indifferent as to whether they can go to the free market with their property or retain it for its stated use. That level of inducement is fairly easy to define and quantify. It strikes me that Congress should take the responsibility of enacting legislation which lays out very clearly

the deals that will be offered to owners to cause them to stay in the program.

Then you need not an office of preservation, but you need an office of implementation that is very responsive and very quick, 90 days start to finish. This should not take 1½ years, as it has in my case, to come to what is a simple economic solution. It has to be implemented with HUD having very clear marching orders, as it were. Take the discretion out of it and it's simple. This is the deal, we want you to stay in the program, you should be indifferent as to whether you stay in the program or not, here is how it is done, this is how we implement it, boom, boom, boom.

Mr. CAMPBELL. A lot of ideas are coming out that we are going to have to follow up on obviously over the next few weeks.

Larry.

Mr. SIMONS. Senator Campbell, three of my former colleagues have stated that HUD definitely has the competency if they want it and if the resources are given to them to handle the problem. I would like to reiterate and echo those feelings.

Now having worked with these three former colleagues on a problem which might have some similarity to what we are dealing with here, and I'm talking about the flexible subsidy program, because I think of what we found when we got there and how we had to deal with it and come up with a program which really gave a project-by-project solution.

We're really not talking about negotiating off of a bace table on every project. I think what we are talking about is establishing a programmatic and policy framework so that the solutions come out on a project-by-project basis. It was done in the flexible subsidy program, and the implementation of the MIO plan was part of the flexible subsidy program.

What you do is you bring the program into headquarters and administer it in headquarters with the best available talent in the Department until you have worked out the kinks and understand all the issues that are going to be faced and until you develop the tools that have to be sent out there, and then the program can be decentralized and put out, and at the same point you'll have the States and local communities working with you to help.

But I think it's important to understand that I don't think anybody at this table is talking about negotiating project-by-project from square one. We are talking about implementing certain broad policy objectives and policy rules and then seeing how they come out on a project-by-project basis.

Mr. CAMPBELL. Yes.

Ms. TORPY. I would like to agree with what Mr. Simons just said. Also, we just did conclude a negotiated deal. It's not concluded, we are under option, but seeing as we did negotiate at the State level, I think a couple of aspects from our experience are applicable here, a few things that we needed.

First, we demonstrated a will to say that housing at the local and State level, that was a priority and that message went clearly out, and the owner approached the State knowing that there was a will there to work with the owner and to do something about that housing.

I think we do need a very clear direction, HUD needs it and everybody out in the field needs a clear direction from Congress on these, and then also the State allocated resources, which is the next thing that we need at the Federal level, and with those resources some tools to work with in negotiation. And then also our levels of Government demonstrated the will to come and leverage other resources available, which in our case was Federal.

Mr. CAMPBELL. John.

Mr. KOELEMIJ. Let me say this again as a small owner and a manager of some properties that are owned by nonprofit sponsors. There is nothing wrong with not being a nonprofit sponsor. To say that they are the only ones that can do it is just absolutely incorrect. There are many failures in nonprofit sponsors. I remember years ago one of the FHA commissioners cried out and said I wish we could do away with them.

I'm not against nonprofit sponsors, but to say that that's the only solution, I disagree with. And I have said before what I think is needed. For example, for a small owner like myself I can stay in the program, and I don't want to opt out and I don't want a "deal". And you will not have to pay grants to the nonprofits to get into an ownership position first and following that you won't have to pay grants to the Public Housing Authority to bail out the non-profit sponsors, when they fail, which has happened in the past.

So I just want to point out that it has its liabilities if you go in that direction on an exclusive basis.

Mr. CAMPBELL. Ms. Percy.

Ms. PERCY. I would just like to say that I think that the present budget needs to be increased for subsidized housing for the owner's standpoint and certainly for the tenants' standpoint. I think that increasing that budget at least by cents more would be a start in the right direction. So that what as a tenant I'm asking you to do.

I have been through many months of stressfulness. In fact, in my situation I have seen people have heart attacks, I have seen people grieve, and I am one of the persons that has grieved over all of the agony it has caused us about the uncertainty of our tomorrow. You know, will these houses remain affordable and will we be able to stay here, and certainly it is a stressful situation.

And I would ask those of you that have the power to make a change to do whatever it is in your power to make that change for all that is involved, the tenants as well as the owners.

Thank you.

Senator CRANSTON. Can I go off to a related but slightly different topic before we close. Much of the written testimony submitted today argues that prepayment is only one of a number of complex preservation issues facing the Congress, and a number of other preservation problems have been mentioned, the defaults on the older subsidized inventory, section 8 opt outs and disposition of full insured or coinsured projects that are defaulted.

What is the nature of the scope of preservation problems other than prepayment, and what are some new initiatives or revisions to existing law that we should be considering as we address these problems?

Yes, Bruce.

Mr. ROZET. It's a favorite subject of mine, Mr. Chairman, as you know.

I think we have a number of issues, but let's just take the abuses. Anything that we do has to start with a concept that is put forward by the Congress and that HUD follows that it is important to preserve the housing resources we have for affordable housing. Unless HUD believes it and operates under that idea, we will never have an effective preservation policy.

For example, you mentioned the coinsurance situation. The coinsurance situation was a known problem 6 to 8 months ago. In the process Ginnie Mae, which is an agency of HUD, is in the process of taking over control of properties that have failed in the coinsurance program and selling them off to speculators at $3,000 and $4,000 and $5,000 a unit, while at the same time, in the very cities that they are doing that in they are providing the housing authority or other groups with $40,000 and $50,000 a unit to provide new housing. That makes no sense whatsoever.

As we sit here within 1 week HUD will auction off a 300-unit housing project in one of the cities in the Southwest, and they will accept a bid as low as $70,000. That is for a 300-unit project. That does not reflect a sense of conservation. That reflects just a total disregard for maintaining housing for low-income housing and for maintaining it affordable.

Properties today go into default and they deteriorate because HUD has a position that says we will only provide enough money to maintain the minimum economic condition of the housing. That's penny-wise and pound-foolish to put chewing gum on the roofs and put paper in the windows and hope that the problem won't come back in 2 or 3 years.

Ms. Percy is shaking her head yes. She has seen it, and all of us working with the projects have seen it.

Until it is made clear that it is the policy of this Government to preserve the housing for affordability, and HUD provides the tools and the section 8 subsidies where needed, stops foreclosing and selling housing to speculators and helps to provide 241 loans on an expeditious basis. To get a 241 loan today takes about a year, and during that year the project has deteriorated even more.

Last, let me address the drug problem, and it was referred to very well by Ms. Percy in saying that when you neglect the housing you get increased crime. When drugs hit a project, that project is destroyed in a year, and we are seeing the spread of crack throughout this country to such a degree that we are losing thousands of housing units annually.

Right now there are no provisions at all in any legislation to provide assistance to private owned, low-income housing to prevent the spread of drugs. HUD has a standing policy in some of their offices not to increase section 8 or provide any assistance for increased security. They say that is the problem of the owner. Owners aren't equipped with AK-47's and they don't know how to deal with that problem. We must have Federal assistance to stop drugs in private housing projects and not just public housing projects.

These are preservation issues. If we don't have a sense that we are trying to preserve what we have, then we will spend tens and

hundreds of billions more to replace that which is destroyed. That makes no sense whatsoever.

Mr. GRADY. I want to concur, echo and say hurrah to everything that Mr. Rozet says. And in addition to that, I want to reemphasize what I said earlier, that I applaud the fact that HUD has taken action to extend the expiring section 8 LMSA contracts, and I want to urge the Congress to make sure that they continue to have the resources to do so because this is one of the best methods to preserve some of the at-risk housing stock.

Senator CRANSTON. Yes.

Mr. SIFLINGER. Mr. Chairman, I don't think that anybody wants to see another bureaucracy created, but I think the idea is creating within HUD an office of affordable housing is an excellent idea because an office with the mission of bringing together the tools that can enhance preservation is absolutely critical. In addition, they can identify the very many blockages that are preventing the preservation of housing.

But one particular issue that common sense tells us is not being adequately addressed is that we have 20-year-old developments that are deteriorating. We do not have sufficient resources to maintain these units in proper physical condition. These units are deteriorating in many cases because willing owners and willing property managers and willing public agencies do not have the resources to adequately address the capital needs of these developments.

Further, if I just may say on the issue of drugs, I will leave with Don a letter that I just sent to Under Secretary Dellibovi regarding the issue of drugs and HUD property disposition in Boston.

Ms. ROGERS. Senator, I think in making my last remark, I would like to say that, as my Governor always does, time is not on our side.

You asked earlier what would happen, or Senator D'Amato did, what would happen if Congress does nothing. If Congress does nothing, the problem is going to get very acute nationwide, and then you will as a Congress have to face the question of where is the bottom and at what does the Nation turn around and decide to house its people because it will go down if you do nothing, and we are in a situation in Maryland at least where every housing unit we have is critical.

So whatever you do, I would urge you to try to get something passed very quickly, and in setting up your administrative structures to deal with the problem, go with what is there now that can do the job and do not rely, please, on rebuilding a capacity that may take 2 years to reconstitute because 2 years from now in many cases will be too late for all of the reasons that people have mentioned here.

Senator CRANSTON. Unless one of you has a burning, compelling need to make another point or to rebut anything, I want to bring this to a close with one brief remark of my own.

Let me thank you all for your help on adding to our understanding of this very difficult issue.

The administration's proposals on this matter, as I guess you all know, are just about finalized.

The subcommittee will be refining the ideas we have gotten today and other thoughts that we had given to us. We will take

into account the administration's proposals and any other suggestions made to us re solid legislation that we will hope to bring to the Senate this fall.

I think we need a working group of manageable size to work with the subcommittee to form legislation that will be effective, and any of you who would like to participate in that working group, which we do have to keep relatively small, please contact Don Campbell and we'll be going on from here.

I thank you all very much for your attendance and for your help. We deeply appreciate it.

We stand adjourned.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[Prepared statements follow:]

STATEMENT
SUBMITTED TO
THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
FOR A HEARING ON
FUTURE LEGISLATION TO PRESERVE EXISTING SUBSIDIZED HOUSING

JUNE 20, 1989

Prepared By
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The twentieth anniversary date of the public-private partnership formed to produce housing for low and moderate income people brings us to a crossroads in national housing policy. Our success in reaffirming and restructuring the old partnership will determine how affordable housing needs are met in the future. What is at stake in the prepayment dilemma is not simply the future of an irreplaceable affordable housing resource -- over 600,000 units produced under the 221(d)(3)(BMIR) and 236 programs, of which 348,500 are eligible for prepayment -- but the prospect for any future collaboration between the for-profit and public sectors in meeting the affordable housing needs of our nation.

The process of renewing and redefining the partnership should be easier than one might expect because of the enormous concentration of ownership and control of the assisted stock. While the size of the entire 221(d)(3)(BMIR) and 236 inventory is substantial, we estimate that ownership and control of the inventory rests with less than 1,000 individuals or entities. Of these 1,000 owners, perhaps as few as 100 entities control more than half of all the projects.

To reestablish the principles of the partnership and move forward with a new compact, the following issues must be resolved:

- What is a fair return on investment to the owner and how should it be achieved?

- What are the respective rights and responsibilities of the federal government and the owners?

- What income groups should be served by this housing and what should tenants be asked to pay for housing costs?

- What steps can be taken to assure the permanent availability and affordability of this housing to low and moderate income people?

- What is the proper role for state and local governments in the preservation effort?

These issues should be resolved in the same spirit, and with the same ethic, which inspired the public-private partnership more than a quarter of a

century ago. That spirit was one of fairness, cooperation and dedication to meeting a compelling social need.

Our testimony today is largely directed to the question of a fair return on investment. We would be happy to address the remaining issues in more depth at a later time.

Fair Return on Investment

A long standing goal of HUD assisted housing programs is to provide owners with a "fair return on investment." As stated by the United States Court of Appeals for the First Circuit:

> The National Housing Act programs administered by HUD are intended to stimulate the development of low and moderate income housing by providing subsidies or insured mortgages designed to lower the cost of building a project and thus lower the rent which owners must charge to make a fair return on their investments.

City of Boston v. Harris, 619 F. 2d 87, 89 (1st Cir. 1980) (emphasis supplied). This objective is also cited in HUD's rent increase regulations, which require HUD to consider the level of rental income necessary to "maintain the economic soundness of the project and a reasonable return on investment consistent with reasonable rents to tenants." 24 C.F.R. 207.19(e).

In fashioning legislation that curtails the right of owners to prepay and maximize the profit potential of the housing, while providing financial inducements to continue participation in the programs, the guiding principle must be "fair return on investment." Incentives designed to provide a "fair return on investment" accord with the Fifth Amendment's guarantee of just compensation. Thetford Properties IV, Ltd. Partnership v. HUD, No. 88-869-CIV-5, slip op. at 5 (E.D. NC., May 26, 1989) (order dismissing owner initiated lawsuit attacking the constitutionality of the Emergency Housing Preservation Act for failure to exhaust administrative remedies.)

Resolution of what is a "fair return on investment" is the linchpin for deciding all of the other issues raised in the beginning of this testimony. Deciding what return an owner is entitled to will determine what additional income must be generated from tenants and the public to provide additional compensation to owners. Any other approach will arbitrarily restructure economic relationships.

Title II, the Emergency Low Income Housing Preservation Act of 1987, has among its purposes the provision of a "fair return on investment" to owners of prepayment eligible projects. But Title II does not define "fair return on investment." On one hand, Title II sets an outer limit on increasing operating income at the lower of 30% of income or the Section 8 Fair Market Rents. This provision could be construed as an effort to balance the owner's interest in a "fair return on investment" with the public's interest in assuring affordability. In the explanation of the interim regulations implementing the statute, however, HUD states that the objective of the incentives are to provide a fair return from the operation of the project. This is different from fair return on investment. Then the Department states that it is not the intent of the rule to "necessarily" provide incentives sufficient to provide the owner with a rate of return equal to the rate of return it would receive if the project were converted to its most profitable use. (Fed. Reg., April 5, 1988, at 11228). However, the regulation implementing the 241 equity take out loan incentive defines equity as the difference between debt and fair market value. 24 C.F.R. 248.201. Things are indeed muddled.

At present, under the administration of Title II by HUD, project incomes are increased in two ways. Rents for Section 8 eligible tenants are increased to the Section 8 Existing Fair Market Rent. Rents for tenants with incomes above 50% of median income are set at 30% of a fixed point of one of four income bands, reflecting the percentage of current tenants in each income band. For example, 30% of 55% of area median income is the rent established for tenants whose incomes fall between 50% and 60% of median income. The smallest family size (a two person household for a two bedroom unit) is used in preparing the new rent schedule. The resulting increased cash flow generated by tenants and public subsidies, whatever the amount, goes to the owner, either in the form of an increased dividend or to service the debt on an equity take-out loan. The owner's actual cash investment in the housing does not factor into the equation.

Industry discussions about incentives and the meaning of a "fair return on investment" currently revolve around notions of fair market value or, at a minimum, paying owners a rent equal to the Section 8 Existing FMRs. We think this is a mistaken premise. Later on in this testimony, we attempt to define the phrase "fair return on investment". The immediately following sections calculate the cost of paying owners fair market value for their properties, or, in the alternative, a rent equal to the Section 8 Existing FMR as suggested by industry members.

Fair Market Value Preservation Cost Estimates

The National Low Income Housing Preservation Commission estimated the cost to be incurred if owners were to receive a return equivalent to the (after tax) net gain if the property were converted to more profitable uses. The Commission's estimates for realizing this return consist of two components. The first component is an up-front payment in the form of a loan taken by either the current owner or a new purchaser which would be equivalent to the equity value of the project if it were converted to market use. The Commission estimates that the up-front payments to owners for the 243,000 units deemed at risk of prepayment, ending in the year 2002, would be $6.5 billion. The second cost element is off-setting future operating deficits in the project through annual operating subsidies. The Commission did not estimate the full cost of the operating subsidy required for all units for a full fifteen year term, which would have taken the operating subsidy through the year 2017. Rather, the Commission calculated only the operating subsidy required through the year 2002, an amount equal to an additional $3.6 billion dollars.

Neither the $6.5 billion in up-front payments or $3.6 billion in operating subsidies would secure permanent low income use of the housing. Owners would receive the current difference between existing debt and market value by adding new debt on the project, which would be serviced by increased rents paid by tenants and the government.

The Cost of Paying A Section 8 FMR Rent

The FY 1989 annual per unit cost of Section 8 LMSA is $3,879, about $325 per unit per month. This is one gauge of the rental rates in the assisted inventory. In contrast, the annual per unit cost of a Section 8 certificate is $6,022 in the FY 1989 budget, about $500 per unit per month. This is an annual differential of $2,143 per unit, which would suggest that rents would have to be increased by this amount to achieve a Section 8 Existing FMR rent level. However, as Mr. Edson suggests, in calculating the increase, the below market interest rate financing must be deducted from the Section 8 Fair Market Rent. Dr. Carla Pedone of the Congressional Budget Office, in her April 26, 1989 memorandum on the budgetary impact of various prepayment incentives, pegs the average increase that would be required to achieve the Section 8 FMR at $1,200. She arrives at this increase by taking the difference between the Section 236 market rents and the Section 8 Existing FMR, using data from the National Low Income Housing Preservation Commission Study and the national average Section 8 FMR.

Assuming CBO's lower figure of a $1,200 per unit annual increase, the cost of preserving the 243,000 units deemed likely to prepay by the Preservation Commission over the remaining twenty year mortgage term is $12 billion. See attached Table "Cost of Increasing Rents of Section 221(d)(3) and 236 Projects At Risk of Prepayment to Section 8 FMRs (Reduced By Mortgage Interest Subsidy) " prepared by the National Housing Trust. This figure is derived by assuming a 5% annual increase to the $1,200 base rent increase and by looking at the number of units that are entering and leaving this preservation system annually. Units enter the system at the point of prepayment eligibility and leave the system at the end of the mortgage term. This may be a low figure, however, because by using the national average FMR it understates the FMR of units located in inflationary real estate markets. The present value of this stream of increased operating income is $4.02 billion.

If we're accurate in our assessment that less than 1,000 owners control this inventory, then what is being proposed is a transfer payment, over time, from tenants and taxpayers to each owner in the amount of $12 million dollars for the privilege of 20 more years of regulated use. Further, Mr. Edson proposes in his testimony that the government could have an option to purchase the housing at the end of the mortgage term for a price equivalent to 10 times the Section 8 fair market rent roll.

In our opinion, neither fair market value nor the Section 8 Existing FMRs provide a proper point of reference for defining "fair return on investment." Both measures compensate the owner for owning a property which happens to be located in an inflationary real estate market. In an action by owners to set aside federal rent regulation on the ground that it did not provide a fair return on investment, the Second Circuit federal court of appeals held that the present fair market value of the regulated property could not be treated as equal to original investment. In the words of the court:

> The complainants appear to assume that present fair (market) value may ... be treated as the equivalent of original investment. We do not think that such an assumption is justifiable. It is common knowledge that fortunes have been built from comparatively small investments in New York real estate as a result of the unearned increment in values which has accompanied the growth of the metropolis over the years.

315 W. 97th Street Realty Co. v. Bowles, 156 F.2d 982,985 (2d. Cir. 1946). Similarly, a fair return on investment in federally assisted housing, built for a

public purpose and provided with ever increasing government investment as detailed below, should not compensate owners for this "unearned increment in values."

Reviewing The History of Program Benefits to Owners

In formulating an approach to the concept of fair return on investment, and assessing the fairness of curtailing the owners' contractual right to prepay and maximize the return from their projects, it is useful to consider the evolution of these programs and changes in the tax laws. The record shows that owners received additional economic benefits and that the risks typically associated with the ownership and operation of rental housing were minimized by the federal government.

The following program tools created after the programs were operational conferred additional economic benefits on the owners and minimized their risk:

- Rent Supplement and Rental Assistance Payment (RAP) subsidies were provided (they are still in effect in most of the state agency financed noninsured Section 236 projects and have been converted to Section 8 LMSA in most of the HUD insured projects)

- 280,000 units of project- based Section 8 rental subsidies were added, in many cases to enable projects to absorb rapid increases in operating expenses during the 1970's

- A Transfer of Physical Assets procedure was created to enable properties to be sold to new ownership

- The partial assignment program, designed to reduce debt service in insured projects, was authorized by Congress in 1978

- Mortgage modification, forbearance and workout policies and procedures were crafted to avoid default and foreclosure

- Many local governments created special real estate tax assessment rates or provided for in lieu payments for federally assisted housing

- HUD preemption of local rent control in 1975, although designed to protect the financial interests of the federal government, often redounded to the owner's financial benefit

- The Flexible Subsidy loan program was created in 1978 and the Capital Improvements Loan program was enacted in the HCDA of 1987

Certainly the most critical real estate risk -- the risk of foreclosure -- is reduced in the subsidized housing sphere. As aptly stated by David Smith in his book, Subsidized Housing As A Tax Shelter (1982) :

> Neither HUD nor the state agencies want to foreclose. Both face all the problems of a conventional lender, plus additional obligations to tenants and other groups. Neither HUD nor a state agency forecloses in the expectation of making money; they do so simply as a last resort, usually to get unambiguous control over a troubled project. (pp. 202-203)

Tax Benefits to Purchasers of Subsidized Housing

The history of tax benefits associated with federally assisted low and moderate income housing, including housing developed under the 221(d)(3)(BMIR) and 236 programs, through the Tax Reform Act of 1976, is reviewed in Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives (Congressional Budget Office, May, 1977). The Economic Recovery Tax Act of 1981 (ERTA) prompted many subsidized housing owners to sell their properties and recognize all or part of the value of their assets. The capital gains bracket was effectively reduced from 28% to 20%, reducing the tax liability of investors. Low income housing also benefitted from phase-out of depreciation recapture. Under ERTA, new and used low income housing projects were given the same favorable tax treatment, 200% declining balance depreciation under a 15 year recovery period. Under the Accelerated Cost Recovery System, 52% of the value of low income housing could be depreciated in the first five years of the holding period, and 80% could be depreciated after 10 years. (Prior to ERTA, used rental housing with a remaining 20 year life was depreciated under a 125% declining balance method. It is important to note that prior to the Tax Reform Act of 1969, used rental housing had to be depreciated on a straight line basis by a purchaser.) In its Preservation Sample, the National Low Income Housing Preservation Commission found that 40% of the inventory changed hands after 1981.

Upon sale of the property, purchasers were able to commence a new cycle of depreciation on the purchase price of the housing. In many cases, the purchase price approximated fair market value because of the inclusion of purchase money notes in depreciable basis. Increased depreciation deductions could be taken on a higher purchase price which included seller financing. In addition, until the Deficit Reduction Tax Act of 1984, acquiring limited partnerships could deduct annually accrued but unpaid interest on the secondary financing, but cash basis sellers were not required to recognize and pay taxes on the interest payments. A tax benefit was derived by the purchaser from this financing without current debt service payments being made.

Certainly the Tax Reform Act of 1986 had adverse consequences for the owners of assisted housing, particularly for those investors who did not qualify for the seven year passive loss transition rule. But it is important to bear in mind that many of the original owners and successive purchasers of projects that are now eligible for prepayment have realized a significant return on investment through tax benefits, and may have additionally benefited through the program tools described above. As the other panelists rightfully point out, any workable preservation strategy will require special tax legislation for these projects.

Establishing A Measure of Fair Return On Investment: A New Proposal

Our proposal for defining a fair return on investment is to determine what an owner's actual investment has been, what return has been received on that investment, and what a fair return on that investment would be, now and in the future.

Step One: Determine Actual Cash Investment

The original project owner developed the housing with a highly leveraged HUD insured loan which reflected 90% of the project development cost. In theory, the owner invested the remaining 10% of the cost of the project. However, HUD project underwriting permitted owners to credit a non-cash amount included in the total development cost, called Builder Sponsor Profit Risk Allowance (BSPRA) toward the equity contribution. Therefore, many of the original developers did not make significant cash investments in the projects. In many cases, the payment of builder and

developer fees was made from equity capital raised from the syndication of partnership interests in the projects. For those original owners who did not syndicate their ownership interests, BSPRA permitted a credit toward the total development cost and the owner's actual investment was the value of foregone development fees. The 6% limited dividend return provided to the owner was calculated on an amount determined by HUD, which approximated 10% of the value of the project, whether or not the owner had actually made any cash investment.

In setting a new definition of "fair return on investment", it should be assumed that the original owner invested at least 10% of the original cost of the project, notwithstanding the BSPRA factor discussed above. Original owners and subsequent transferees would, however, still be able to show what their actual cash investment in a project has been. For the original owner, this would include any cost overruns that were covered, and any cash advances made to the project, for operating deficits or repairs or other purposes, during the term of its ownership. For the transferee (the second or third project owner), the actual cash investment in a project would be the combination of (1) the cash portion of the purchase price; (2) project related investment recognized by HUD under its Transfer of Physical Assets rules at the time of purchase; and (3) any additional post-transfer cash advances made to the project for operating deficits, repairs or other project-related purposes.

Step Two: Increase Original Stated Equity By Inflation Factor
And Increase Rate of Return From 6% to 10%

Once the owner's cash investment is determined, the rate of return on this investment should be increased prospectively from 6% to 10%. A 10% rate of return is the rate established by HUD for determining a limited dividend return on family Section 8 developments. In addition, original owners should be permitted to have the value of their original investment (which would be deemed to be not less than 10% of the original cost of the project) increased by an inflation factor, such as the CPI, over the period of future project ownership. This deemed equity investment would be added to any actual cash advances to the project and a 10% return taken on the total. This stated equity floor would continue to be increased each year by an inflation factor.

Step Three: Pay Out Accumulated Unpaid Allowable Distributions (6% Limited Dividend Return) Or Credit This Amount to Owner Investment In Project

Owners who choose to stay in the program would have their equity recalculated and the rate of return increased from 6% to 10% as described above. In addition, owners should be entitled to receive, in a lump sum payment, any accumulated unpaid 6% limited dividend distributions at the time this new economic relationship is structured (the twentieth anniversary date of the HUD mortgage). This establishes an important principle of making owners whole for the annual 6% limited dividend which was provided for under the programs as enacted. This lump sum payment of the annual allowable distribution, that was earned during the current owner's period of ownership but was never received, would be paid out of any project residual receipt accounts. The balance (or the entire amount if there are no residual receipts) would be paid directly by the federal government. In the alternative, the owner could elect not to receive the lump sum cash payment, but rather to have any accumulated unpaid distributions credited towards its cash investment in the project, on which the future 10% return will be taken.

Step Four: Offer A Buy-Out Option And Prescribe The Cash Portion of The Purchase Price

If an owner wishes to sell the project, the cash portion of the purchase price would be fixed at the net present value of the stream of limited dividend distributions that could be taken over the remaining useful life of the project under the formula describe above. The remaining useful life would be deemed to be the remaining mortgage term plus ten years. The tax laws should be amended to provide a favorable treatment of such a sale. A two or three year window should be created during which ownership interests could be sold or transferred without any tax due except on cash actually received. This incentive, more than any other single change, would satisfy investment backed expectations of the many passive investors in these projects and eliminate the need to generate cash on disposition in order to meet the seller's tax liabilities. Special consideration should be given to the tax treatment of purchase money notes on these projects, since there would be insufficient funds to pay them off under this program. In addition, since the cash portion of the purchase price would be restricted, consideration should be given to taxing the cash received at a rate below ordinary income rates. Properties sold under this program would be dedicated to continued low and moderate income use for the remaining useful life of the property.

Allow Certain Original Owners To Sell For Full Fair Market Value For Permanent Low Income Use

Original owners of these projects who did not syndicate ownership interests and did not receive any additional rental subsidies or benefit from any of the program tools listed in the preceding section of this testimony should get the benefit of the original agreement, the unrestricted right to prepay after twenty years. In this case, for profit, nonprofits and government agencies should be provided a right to purchase at fair market value and assume the low interest debt if they agree to maintain low income occupancy for the the remaining useful life of the project. We believe that very few owners will meet these standards. But those who do should be entitled to the benefit of the original bargain, the opportunity to realize the appreciated value of the housing after twenty years of government regulated use.

Hold Harmless Certain Recent Purchasers Of Prepayment Eligible Projects

Another category of owners deserves special consideration: those who (1) purchased projects within three years of their prepayment eligibility date; (2) did not receive the benefit of special depreciation rules for low income housing because of the Tax Reform Act of 1986; and (3) financed the acquisition of these projects with bona fide third party debt, secured by partnership interests, personal guarantees or other valuable collateral. These owners detrimentally relied on the contractual right to prepay and convert the housing to more profitable uses, and stand to lose more than their actual cash investment in the property if their original conversion plans are stymied. The federal government should take-out these third party loans, and negotiate a buy-out of these properties.

We firmly believe that the appropriate point of departure for the resolution of the prepayment issue is to determine what the owner's investment was in this housing and what is a fair return on that investment. We have suggested an approach which requires further thought, analysis and more detail, but its goals are clear. It would take into consideration the different circumstances of owners and reward their investment. While providing a fair return to owners, it would minimize the additional payments to be made by tenants and the government. In dealing with each project individually, the objective would be to assure that long term appreciation in value is retained for permanent affordability and maintenance of the housing in good condition. In this way, the realistic economic expectations of the public-private partnership can be fulfilled and the housing built by that partnership will remain available for the purpose intended.

Finally, it should be noted that the National Housing Trust was formed more than two years ago to act to preserve this stock of affordable housing. It was also created to be a forum for the debate of these critical issues. The evidence of the vigor of that debate is found in the fact that there are four members of the Board of the National Housing Trust presenting their own testimony here today. The Board does not represent a single position. But we are confident that the principles of fairness, cooperation and the desire to serve the critical housing needs of the American people will prevail in the outcome of this debate.

COST OF INCREASING RENTS OF PROJECTS
AT RISK OF PREPAYMENT TO THE SECTION 8 FMR'S
(REDUCED BY MORTGAGE INTEREST SUBSIDY)

YEAR	BASE INCREASE + 5% PER YEAR	NUMBER OF UNITS ENTERING SYSTEM PER YEAR	NUMBER OF UNITS LEAVING SYSTEM	UNITS IN SYSTEM	INCREMENTAL ANNUAL COST	TOTAL ANNUAL COST	NET PRESENT VALUE @ 8% DISCOUNT
1990	$1,200	16,620	0	16,620	$19,944,000	$19,944,000	
1991	$1,260	32,400	0	49,020	$40,824,000	$61,765,200	
1992	$1,323	54,410	0	103,430	$71,984,430	$136,837,890	
1993	$1,389	33,000	0	136,430	$45,841,950	$189,521,735	
1994	$1,459	20,270	0	156,700	$29,565,974	$228,563,795	
1995	$1,532	11,350	0	168,050	$17,382,955	$257,374,940	
1996	$1,608	10,510	0	178,560	$16,901,286	$287,144,973	
1997	$1,689	15,740	0	194,300	$26,577,313	$328,079,535	
1998	$1,773	17,070	0	211,370	$30,264,197	$374,767,709	
1999	$1,862	17,080	0	228,450	$31,796,023	$425,281,117	
2000	$1,955	4,450	0	232,900	$8,698,297	$455,243,470	
2001	$2,052	3,390	0	236,290	$6,957,661	$484,963,304	
2002	$2,155	6,720	0	243,010	$14,481,785	$523,693,255	
2003	$2,263	0	0	243,010	$0	$549,877,918	
2004	$2,376	0	0	243,010	$0	$577,371,814	
2005	$2,495	0	0	243,010	$0	$606,240,404	
2006	$2,619	0	0	243,010	$0	$636,552,424	
2007	$2,750	0	0	243,010	$0	$668,380,048	
2008	$2,888	0	0	243,010	$0	$701,799,048	
2009	$3,032	0	0	243,010	$0	$736,889,000	
2010	$3,184	0	16,620	226,390	$0	$720,816,081	
2011	$3,343	0	32,400	193,990	$0	$648,538,659	
2012	$3,510	0	54,410	139,580	$0	$489,969,470	
2013	$3,686	0	33,000	106,580	$0	$392,835,602	
2014	$3,870	0	20,270	86,310	$0	$334,030,051	
2015	$4,064	0	11,350	74,960	$0	$304,609,400	
2016	$4,267	0	10,510	64,450	$0	$274,995,726	
2017	$4,480	0	15,740	48,710	$0	$218,227,989	
2018	$4,704	0	17,070	31,640	$0	$148,839,463	
2019	$4,939	0	17,080	14,560	$0	$71,917,121	
2020	$5,186	0	4,450	10,110	$0	$52,433,805	
2021	$5,446	0	3,390	6,720	$0	$36,596,750	
2022	$5,718	0	6,720	0		$0	
					TOTAL COST	$11,944,079,694	$4,020,947,935

Prepared by The National Housing Trust, June 20, 1989.

Roundtable Hearing of the Senate Subcommittee on Housing and Urban Affairs Concerning Potential Loss of Low-Income Affordability in Privately Owned, Federally Subsidized Rental Units

By
Lawrence B. Simons
Chairman
Affordable Housing Preservation Center

I. INTRODUCTION

The discussion in this paper will be limited to the threat of mortgage prepayment, after the 20-year prepayment restriction has expired, by owners of below-market interest rate ("BMIR") and Section 236 properties. When current market rent levels are high and a shortage of units at that level exists, owners have the incentive to increase the current value of their projects by prepaying the federally-insured mortgage, thereby removing any rental restrictions attached to the property. Owners may then increase rents to then-market rates, or convert the project into condominiums or coop units. In this way, prepayment threatens the affordability and availability of low and moderate income housing. Developing new incentives, or improving existing ones, to discourage prepayment and its consequences will be the focus of this paper.

Public interest groups concerned with low and moderate income housing agree that the public policy resolutions to this threat should embody two goals: 1) preserving affordable housing stock for low and moderate income tenants, and 2) enabling owners to receive a fair return on their projects. The issue thus revolves around money, and specifically, the achievement of financial fairness to prospective and existing low and moderate income tenants, as well as owners. Tenants should pay only affordable rents; owners should receive a fair return on their projects. The Housing and Community Development Act of 1987 has no clear definition of "fair return." Although the Act uses the phrase, "Fair return on the investment of the Owner," the 241(f) provision (FHA-insured second mortgage for borrowing out the owner's equity) uses the phrase "value of the equity as determined by the Secretary" as the limit on value, and the regulation implementing this provision defines equity as the difference between "fair market value" and existing mortgages. Obviously, the pragmatic definition of "fair return to the Owner" is what will be sufficient incentive for the owner to refrain from prepaying. To attain an equitable balance between the above goals, Congress must address two issues: 1) what resources are available to increase the net operating income of a project; 2) what process should be implemented to promote the most efficient use of these resources.

II. FINANCIAL RESOURCES

A. Continuing Participation in Federal Programs As a Form of Owner Compensation

Continued, satisfactory participation by the owner in the current program is in itself a financial incentive. Changing existing federally-insured projects to fair rental value, or

condominiums or coop units, will render projects more vulnerable to the risks inherent in the market. Further, such a transformation usually will require changing the tenancy of the project, a disruptive, time-consuming and costly process at best. If the alternative is financial predictability, or a comforting level of rent, participation in these federal programs becomes more attractive. Finally, existing Tax Code provisions create financial incentives for continued ownership by permitting owners of covered projects to borrow out their equity, a much more advantageous tax situation than the full taxable transfer of the property to achieve the same goal. In addition, in many situations, transfer of ownership will trigger taxable consequences.

Owners will be willing to receive less than the full fair market return on their properties if they can avoid costly situations and uncertainties. The difficulty arises when one attempts to quantify the value to the owner of these programmatic incentives: such values will vary depending upon the nature of the ownership and the individual location of the property. The National Low Income Housing Preservation Commission's Preservation Analysis Model, which attempts to quantify some of these financial incentives and owner benefits, could serve as a starting point for a study to determine the amount of return on the property, below current fair market return, that would be acceptable to an owner in exchange for incentives built into these programs.

Two additional incentives could render the value of continued participation in these programs even higher. First, HUD and FHA programs could incorporate a process for early negotiation with regard to owner prepayment. Permitting negotiation earlier than two years prior to the expiration of the 20-year restriction will provide desired financial certainty to owners, and at the same time decrease program costs since negotiations will be conducted before the market situation has been clearly defined. In addition, the programs could provide for some form of tax forgiveness, with no additional subsidy, for owners who transfer to a non-profit or commit to a long-term low and moderate income project after 8 to 10 years of ownership, so long as the project is in good condition and not in default.

B. Reducing Operating Expenses as a Means of Increasing Net Operating Income.

The Housing and Community Development Act of 1987 attempted to create a new housing program without first analyzing the existing BMIR and Section 236 programs for any potential cost savings within these programs which could reduce operating expenses, and thereby increase the owner's income stream on the

project. I do not believe the BMIR program holds much potential for operating expense reduction, since interest rates on BMIR mortgages are so low. However, the potential for increasing the income stream of Section 236 projects does exist since under that program mortgages are written at rates of 7 to 8 percent.

A financing mechanism that defeases the Section 236 mortgage and yet permits continuation of the Section 236 subsidy would provide an incentive for the project to continue as low and moderate income housing since it could reduce the amount of mortgage to be serviced. A potential mechanism could be the defeasance of Section 236 loans using tax-exempt financing, without the loss of the accompanying interest reduction subsidy. Currently, defeasance of Section 236 mortgages results in termination of this subsidy.

Local public housing authorities ("PHAs"), who now have tax-exempt financing powers, should be encouraged to purchase projects without loss of the federal subsidy. PHA ownership will result in real tax savings, and management savings may result. Reductions in the project's operating expenses would result since PHAs must make only "payments in lieu of taxes" ("PILOT"), which are the equivalent of real estate taxes but are set at much lower rates. The original owner would be fairly compensated by the PHA purchaser, and the operating expense savings available to the PHA will provide it with some of the necessary cash flow in order to meet the debt burden of the payment to the owner.

The surplus funds now generated by Section 236 projects are another potential area of cost savings that may be passed on to the owner. The surplus funds may be used to reduce operating expenses, e.g., by servicing secondary debt in connection with the acquisition of these projects, or, to enhance the income stream of the project.

Financial analysts should examine the current situation to determine means to increase the income stream of participating projects by reducing operating and debt service expenses. The study should be conducted from the perspective of easing the burdens that projects carry under the present legal and statutory structures, so that new financial mechanisms may be created within the constructs of the existing BMIR and Section 236 programs.

C. Increasing Tenant Rents as a Means of Increasing Net Operating Income

As the statutory scheme is currently structured, existing and new tenants with incomes of 50 percent or less than median income usually receive Section 8 subsidies or vouchers. The most

difficult area in dealing with rents comes in the low income range of 51 to 80 percent of median income. This also, in many instances, is the critical rental range for additional income.

The Housing and Community Development Act of 1987 contemplates the need for a statutory fixed rent. This is absolutely correct. However, the level at which rents for tenants in the 51 to 80 percent range should be set remains unclear. Currently, HUD has agreed to tier the rents in the 51 to 80 percent range by creating three tiers -- 51 to 60 percent, 61 to 70 percent, and 71 to 80 percent -- with the fixed rent level based upon a median income at the mid-point of each of these tiers. Using this method of setting rents is intended to minimize rent burden in excess of 30 percent of tenant's income. The corollary issue here is the family size definition for apartment size. If it is felt that this should be set conservatively, such as 1.5 persons per bedroom, as is proposed in the pending Low Income Tax Credit legislation, then it seems to me that this should only be a threshold, and a higher tier of rent should be permitted for higher occupancy.

While no one wants to place undue rent burdens on tenants, since we must have a fixed rent, there will be situations in the 51 to 80 percent range where tenants are paying over 30 percent of their income for rent. If we are to break this median income range into three tiers, use of a conservative standard for occupancy will result in unduly low rents and at the same time provide a rent payment of far less than 30 percent of income for some tenants. Although this is a sound objective of public policy, I would suggest using existing Section 8 subsidies or vouchers to achieve this goal. If we are to find sufficient financial resources to provide an incentive to the owner, a more liberal view of occupancy should be adopted.

The precedent for paying rent of more than 30 percent of income exists within the structure of several HUD programs. For example, in the Section 236 program a tenant paying base rent is paying at least 30 percent of income, and may be paying substantially more. I would suggest an analysis of the range of options, using occupancy levels and unit sizes as means of determining rent levels, and analyzing HUD's proposed tiering approach as well. One policy that should be cast in stone is permitting regular rent increases once the rent levels have been established. If the owner can expect his return to grow with time, he may be more willing to receive a smaller return now.

D. Direct Federal Subsidies

The above sources of funds -- the financial benefits of participation in HUD programs, reductions in current operating

and debt service expenses, and increases in tenant rents -- do not bear any cost to the government. These contributions must be supplemented by federal government subsidy programs that fill the gap between the return resulting from these actions, and a fair return on the property. The National Low Income Preservation Commission has stated that the primary entity responsible for filling this gap is the federal government. Connecting owner incentives with certain tax consequences should reduce the direct cost to the government. This method of federal government involvement with housing is not uncommon. Without some resource provided by the government, HUD is helpless to try and fill the gap. Providing Section 8 subsidies for very low income tenants is sound policy, but normally just not enough. There must be an ultimate source of funds available to HUD if there is to be any hope of achieving the delicate balance of the interests of tenants and owners.

III. IMPLEMENTING A PROCESS FOR EFFICIENT USE OF THESE RESOURCES

To construct the most efficient process for using these potential sources of owner compensation, a realistic understanding of the differences among the projects, their ownership and their operation must be developed. Four distinct types of situations arise in this context: 1) the original owner of a project that has never been syndicated; 2) the original owner of a project that has been syndicated; 3) the new owner of a project that has been transferred and not syndicated, which has simply second debt as a result of the transfer; 4) the new owner of a resyndicated project, which has secondary debt now as a result of the resyndication. Each situation yields a different set of financial facts, and involves an owner with a different set of objectives. Consequently, the incentive necessary to induce the owner to refrain from prepayment will differ depending upon the specific ownership situation. In creating an efficient process for using the incentives and subsidy, the following question must be asked for each individual situation: how much will be gained by increasing rent levels, by reducing the operating costs, or by requesting that the owner accept less than a fair market return since by continuing to participate in the program he will not have to face certain difficulties and uncertainties.

Presently, HUD is slowly making policy decisions which we hope will lead to more rapid implementation of this process. Part of the solution is in obtaining a predictable financial resource other than Section 8.

Perhaps the Flexible Subsidy Program gives us an analogy to creating the process. There, an extensive study was made of the status of Section 236 projects. From that study, a program was

designed which enabled HUD staff and owners to understand the factors and decisions which went into the decision making process. Here, with the prepayment problem, judgmental decisions must be made. The model of the Low Income Preservation Commission may be a good starting point to analyze and set forth the many factors that enter into the owner's decision. An analytical program must be developed from that for the implementation. It will eventually result in a negotiation with the owner and not every decision will be perfect. What can be achieved is predictability and certainty, both of which have intrinsic value to owners.

Arguments against appropriating funds to carry out the provisions of Title II of the National Housing Act often focus on the dearth of information available to enact a permanent solution to the prepayment problem. This is a "chicken and egg" problem. We have enough information to know that a problem exists. The information we now need is the precise quantification of the problem and the process that must be implemented to solve it. The only way to gain this information is by proceeding with creation of the process within public policy parameters, and actual implementation of the process to ascertain its effectiveness.

STATEMENT OF

A. BRUCE ROZET

CHAIRMAN OF THE BOARD

ASSOCIATED FINANCIAL CORPORATION

SUBMITTED TO

THE SENATE SUBCOMMITTEE ON HOUSING & URBAN AFFAIRS

OF THE

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

OF THE

UNITED STATES SENATE

JUNE 1, 1989

Associated Financial Corporation
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THE PRESERVATION OF EXISTING FEDERALLY SUBSIDIZED HOUSING STOCK

Introduction

This paper focuses on the issues involved in the prepayment of HUD mortgages and the subsequent conversion of the housing to fair market values. Today's prepayment issue is rooted in housing and tax legislation of 1968 and 1969. The purpose of that legislation was to increase the production of new and substantially rehabilitated housing by providing incentives to private capital, developers, and investors, to increase the nation's supply of affordable housing. That legislation was effective in achieving its goal but in the rush to produce, we neglected to consider the need to preserve. If the past twenty years of national housing policy is flawed, it is primarily in the failure to recognize that the preservation of the housing we have and the housing we build is the most effective way to assure that we will continue to have an adequate supply of affordable housing.

Preservation of low income housing however, reaches far beyond the prepayment and Section 8 opt out issues. Housing and tax legislation in 1989 and 1990 must address the broad spectrum of Preservation issues to avoid the continuing cycle of patchwork solutions to maintaining an adequate supply of low income housing for the millions of families unable to afford market rents. Today as we discuss Preservation, HUD and Congress permit existing federally assisted housing to deteriorate or to be sold off to speculators at bargain prices. Until Congress and HUD agree on a program to Preserve the existing stock, we will continue to face a loss of valuable low income housing. The programs we evolve for avoiding prepayment must also be extended to avoid housing deterioration and abandonment and permit revitalization and preservation of all federally assisted housing to assure future viability.

Background

The economic conditions creating the prepayment crisis reflect the inflationary and growth trends of the past 15 to 20 years. The properties most threatened with prepayment were built at a time when the cost of construction was $10,000 to $15,000 per apartment unit compared to today's construction cost of $50,000 to $100,000 per unit unit in most parts of the country. In 1968, most rents were $150 to $200 per unit. Today, they may range from $450 to $1,000 per unit for "affordable" rents.

The housing stock we are trying to protect from prepayment have regulatory agreements limiting occupancy to families with incomes that do not exceed 80% (Sec. 236) or 95% (Sec.221(D)(3)) of median income. Based on today's median family incomes, and assuming that tenants paid no more than 30% of their income in rent, those same projects could be renting at

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average rents of $650 to $750 per month and still be in compliance with their regulatory agreements. In fact, most of the projects threatening prepayment have below market rents averaging about $375 to $425 per month. By regulation, rents have been restricted to the lowest level required to meet the economic needs of the property and to provide a restricted cash distribution to owners. As a result, these properties have an economic mix of tenants heavily skewed to those of very low income with some Sec. 8 rental subsidy.

Owner's Perception

In effect, these endangered properties are today renting at 50% to 60% of market rents in their area primarily because of their low mortgage debt of $10,000 to $15,000 per unit. With the exception of a few urban areas where current economic conditions have created a temporary housing glut, most urban rental markets can support mortgage debt of $30,000 to $60,000 per rental unit or approximately 2 to 5 times the mortgage debt on prospective prepayment properties. This difference - between the existing $10,000 - $15,000 per unit mortgage on assisted projects built in 1968 - 1974, and the prevailing market condition of $30,000 - $60,000 per unit of debt that property can economically carry, represents the equity value perceived by owners. In current economic terms, owners can calculate that their property has a value of $25,000 to $50,000 per unit if they can prepay their HUD mortgage and/or opt out of their Sec. 8 contracts.

Admittedly, this was not the intent of the housing and tax legislation of 1968/69. Investors provided the capital to build the housing primarily for tax benefits which provided a reasonable return on their investment, but did leave a lingering residual tax problem. The owners have a significant tax obligation if they sell the property because of tax losses taken over the past years.

The 1968/69 legislation did contain an incentive for Preservation for low income use. Section 1039 permitted owners to sell to tenants groups and avoid a tax payment by reinvesting in another low income property. This provision of the tax law has rarely been used and is not effective today without some tax law modifications. It is safe to assume however, that the investors of the early seventies - today's prospective prepayment owners - minimally expected to recover their investment net of tax liability. Because of vast increases in property values, investors now perceive the potential of even higher profits from prepayment than initially contemplated. Somewhere between the payment of tax liabilities and the realization of full market value lies the cost of incentives to encourage owners to retain their properties for the existing tenants. Owners can determine the full market potential of their property but the realization of that value may require the investment of additional capital, meet tenant and local government resistance and involve certain economic risks. Most owners will therefore accept a negotiated solution with HUD that,

though it will result in a lesser dollar value to them, will be quick and certain and involve less risk. This perception of owner self-interest is the starting point for designing incentives.

Public-Private Objectives

The objectives of the respective parties involved must be clearly understood to design enabling legislation and administrative procedures. The government position must be to preserve the housing for the existing tenants at the least cost to the government. The owners must be willing to accept less net after tax than might be available by freely marketizing their property and thereby displacing the tenants. The incentives must reach this balance between public and private interests in an efficient and timely manner.

Program Administration

The provisions of the 1987 Act herded the parties to the dilemma into the corral by the moratorium on prepayment. The Act provides certain options in lieu of prepayment. However, once in the corral, the parties could not find anyone with whom to negotiate. No one had an understanding of the issues or the resources to negotiate a compromise. The administration of the program must be sensitive to the conflicting economic forces at work and to the disruption and trauma to the tenants caused by uncertainty and threat of displacement.

The first essential element that must be addressed is the administration of the program - whatever it may be. Since HUD is the administrative agency involved, it must be capable of formulating effective solutions and agreements with owners in a timely manner. In other words, owners must be able to come to the table, negotiate a transaction and close. Delays in the process will only aggravate the problems, lead to greater cost to the government and cause tenant problems. For example, if a loan program such as the 241 equity loan is to be used, HUD must revamp its current loan underwriting procedures. Today, HUD lacks the staff to carry out loan underwriting of this kind. Loan underwriting is currently in the production department not in the housing management area which is concerned with Preservation. There have been only a few 241 loans underwritten in the past several years. This one phase of the program, 241 loan underwriting, requires extensive reorientation and additions to HUD staff if it is to be a useful tool. All Preservation administration should be coordinated through an administrative group trained to deal with the issues involved and capable of acting expeditiously to close a transaction. I doubt that HUD staff would argue with this assessment but any new legislation should recognize that the administrative effort is essential to success, and state the clear intent of Congress as well as provide the resources to make prepayment options work.

Reconstructing the Rent Roll

The 1987 Act package of incentives are extensive but lack the type of definition necessary to bring about effective action. The parameters of the problem can be quantified to make the program workable.

The Preservation objective is to maintain the property for the existing tenants or a continuing mix of residents at the median income levels that currently exist. Furthermore, tenants should not pay rents higher than 30% of their incomes. By surveying the income of existing tenants a determination can be made as to the potential rental income. Those tenants paying less than 30% of income can be brought to market rents or the rent level at which they will be paying 30% of income in rent. Existing Sec. 8 contracts can be brought to market rent or HUD Fair Market Rent whichever is lower. Those with incomes less than 50% of median not now receiving Sec. 8 rent subsidy should be covered by providing additional Sec. 8 assistance.

Reaching agreement on a new prospective rent roll becomes the basis for designing all legislative incentives. All incentives follow the reconstructed rent roll.

Attached as schedules to this paper are a series of examples of actual projects facing prepayment options. The schedules show various owner options ranging from conversion to condominiums to use of incentives for continuing low income tenancy. In arriving at a solution to retain the existing tenants, a formula of five different rent levels was established as follows:

Tenant Income	Rent Roll
Below 50% median	Section 8 at FMR or MR
50 - 60%	30% of 55% of median
60 - 70%	30% of 65% of median
70 - 80%	30% of 75% of median
80 -	30% of 88% of median

In most cases adjusting the rents of existing tenants who have incomes above 50% of median to rents at 30% of their income would involve large rent increases. Therefore, the new rents would be phased in over 2 to 4 years. All Sec. 8 rents were brought to market in the first year. At the end of the phase-in period, all tenants would pay 30% of their income in rent.

This approach recasts the economic model of the project to serve all parties. Some tenants will pay higher rent, but no more than 30% of their income. The government will incur additional cost because of increased Sec. 8 rent subsidy, but this cost will be considerably less than subsidizing rents in new or moderate rehabilitation construction or in providing vouchers to find alternative housing. The owner will receive less than he could freely realize from the property, but will be

faced with less risk and upheaval.

Alternative Solutions

This rent restructuring allows for the use of several incentives provided in the 1987 Act.

1. Distribution restrictions can be removed.
2. Secondary financing can be permitted.
3. Additional rent subsidy can be provided to protect very low income tenants.
4. A 241 equity loan can be underwritten to access equity and to provide for a transition in rent increases.

Two classes of solution are now available.

A. Continued Private Ownership

1. Increased Cash Flow - Owners can be permitted to retain the cash flow generated from operations as income without limitation having agreed to maintain the property at the agreed economic mix. This agreement can be a deed restriction.

2. Secondary Financing - The owner can further be permitted to obtain secondary financing in the form of a 241(f) loan or conventional mortgage to access the equity created by the revised project economics.

This Preservation approach serves to permit the existing owner to retain ownership of the property with assurance to the government of its continued use for existing tenants.

B. Tenant Ownership

As a matter of National Housing Policy, it may be more desirable to transfer control or ownership of the property to the tenants or a community non-profit group dedicated to housing Preservation. In the final analysis, the tenants should be the preferred owners, but the intervention of qualified community non-profits may be a necessary interim step to assist tenants in organizing and developing skills for housing ownership.

Any program for a transfer of ownership to tenants must involve discussion of the financial implications of a sale of the property. Owners will be confronted with a significant tax liability on sale which will increase the cost of the Preservation program. In the continued private ownership option discussed above utilizing financing incentives, the owners pay no tax by borrowing their equity from a 241 loan making that alternative attractive. If the property is sold to the tenants, however, the owner is faced with a tax on his negative capital account as well as the cash received from the sale. This additional funding requirement will increase the cost to the tenants or

purchasing non-profit organization requiring additional subsidy to keep the rents affordable. Several alternative approaches can be considered to achieve the desired result of tenant control or ownership without increasing the Preservation cost.

(1) Tenant Lease - The existing owners can enter into a lease agreement with a tenant cooperative. The tenants, with the assistance of community non-profit housing groups, where needed, would form a non-profit housing cooperative. The owners and the tenants would negotiate a lease arrangement whereby the tenants would agree to a modified rent roll phased in over a period of time. This reconstructed rent could be similar to the approach discussed above. Based on the agreed restructured rents, the tenants cooperative would contract for an annual lease payment to be paid to the owner. In turn, the tenants would assume total control of the property including property management. The lease could be for any period of time, (i.e. 50 years) giving the cooperative total control and responsibility for the property. The owner could in turn finance the lease to obtain a cash payment or continue to receive the annual cash flow from the lease. The lease could provide the cooperative the option to purchase the property at a future date. After the owners and tenants have reached agreement, the lease arrangement would require HUD's approval, and HUD's agreement to provide the additional Sec. 8 rent subsidy if needed for very low income tenants. This option has the advantage of causing the owners and tenants to reach an accommodation prior to HUD's involvement and allows for the development of a phased rent schedule independent of the underwriting terms of an equity loan.

(2) Eliminate the Owner's Tax Liability on Sale - The original 1039 provision of the 1968/69 Housing Tax bills provided the incentive for transferring ownership to a tenant group. However, that provision required a reinvestment of the sales proceeds in another low income property with the owner retaining his basis in the property. The reinvestment requirement is not feasible today, but the intent of the 1039 provision could be achieved by providing that any sale to a tenant cooperative or tenant owning entity will be taxed only to the extent of cash received by the Seller. Legislation to achieve this result has been introduced in the House and Senate and could be modified and narrowed to facilitate tenant ownership. This tax law change would reduce the Preservation cost because of the reduced cost of acquiring the property. It would not result in a cost to the Treasury because without this incentive most owners will not sell and pay the taxes due on sale for several years. In fact, the Treasury should realize a net gain by this provision, since

(i) it will encourage owners to sell to tenants and owners will pay a tax on cash received;

(ii) the government will incur a smaller rent subsidy obligation due to the reduced purchase price by the tenants.

A reduction of tax on sale is an important component to the Preservation issue. If properly defined and administered, it can significantly reduce the cost to the government to preserve existing housing.

(3) Redirect the Tax Receipts from Sale to Tenants - The sale by an owner to a tenant cooperative under present tax law results in a significant tax payment by the seller to the government. This tax liability will be added to the selling price to permit the owner to retain his equity net after tax. In effect, the cost to the buyer, (i.e., the tenant cooperative) will increase by the amount of the owner's tax liability. In turn, the government will receive, currently, tax revenues that might not normally be received for more than ten years. The government could redirect these "windfall" tax receipts from owners who sell to tenant cooperatives to reduce the cost of the Preservation program. They could be administered by HUD similar to the Flexible Subsidy or Capital Improvement funds to provide "soft" subordinated mortgage loans to the tenant cooperatives to pay a portion of the purchase price or to offset the increased rent subsidy required for very low income families. In effect, the government would be rechanneling the windfall tax receipts back to the properties to preserve their affordability.

(4) Authorize the Use of 501(C)(3) Tax Free Bonds for Use by Tenant Cooperatives to Acquire Their Housing Projects - The use of favorable rate financing will enhance the tenant cooperative's ability to acquire the housing with an affordable rent structure and a reduced rental subsidy cost to the government. If this financing is coupled with either of the two tax on sale modifications, it results in the lowest cost to government to create tenant ownership and housing Preservation in one transaction.

The schedules that follow analyze owner's options in four actual projects now qualified for prepayment. The analyses provide a comparison of the economic results to the owners as well as the effect to the existing tenants. The schedules project the results of Preservation options of two types:

1. Accessing equity through cash flow or 241(f) loan financing;
2. Sale or lease to a tenant cooperative.

The Preservation options are a realistic approach to reaching an agreement with owners to

retain the property for the existing tenants. Each party to the transaction contributes to the end result. Some tenants pay additional rent, but never more than 30% of median income. The government will absorb some cost of additional rent subsidy for very low income tenants. Owners will realize less than they might receive from a free market sale, but a reasonable amount considering past benefits.

If the tax liability on sale in Option 3 or the deferred tax liability on Option 4 were reduced, the cost of these options would be lowered resulting in a major reduction of the government's cost of additional rent subsidy. In some instances, modification of the tax laws impacting the sale of low income projects as discussed in this paper will result in little or no requirement for an increase in rent subsidy.

STATEMENT OF DANIEL B. GRADY

Prepared for the Senate Subcommittee
on
Housing and Urban Affairs
for a hearing on
June 20, 1989

My name is Daniel Grady and I am the president of Monfric, a firm based in San Diego, California which has been engaged in the development and management of assisted housing since the late 1960's. I am the Immediate Past Chairman of the National Advisory Council of HUD Managing Agents. I am also this year serving as Chairman of the Management Subcommittee of the National Association of Home Builders (NAHB).

The National Advisory Council sponsored The National Housing Preservation Task Force which issued in February, 1988 its' report "Preservation of Low and Moderate Income Housing in The United States of America". The basic conclusions of the Task Force are just as valid today as they were then. NAHB at its' recent Board of Directors meeting, passed a resolution supporting those conclusions. They are :

"Every reasonable effort must be made to preserve the existing stock of privately owned, low and moderate income housing.

For these efforts to be productive, it is essential that there be a revitalization of the earlier public/private partnership. The Federal Government should serve as the convener of this revitalized partnership. In turn, state and local governments and private owners must actively work with the Federal Government.

While the solutions must be individually structured to fit the unique circumstances of each project, they should all fall within one or more of the following three categories:

- incentives to induce owners to retain their projects' low and moderate income character.
- long-term renewal of project-based rent subsidy contract.
- low-interest loans for project repairs and improvements.

All tenants should pay a fair share of their income for rent.
Preventive action taken should be of a long-term nature.
Owners should take into consideration the needs of their tenants and should be responsive to offers of governmental incentives to deter prepayment".

I. EXPIRING SUBSIDIES

The Congress acted wisely in 1987 and again in 1988 when it directed the Administration to extend the project based subsidy contracts. We are pleased to note that the new Administration is indeed implementing the law at least within the available budget authority. We applaud this new spirit of cooperation and now urge the Congress to take appropriate action to provide sufficient resources to fully implement the Housing and Community Development Act of 1987.

II. PREPAYMENT ISSUES

To support our recommendations on the prepayment issue we believe it is wise to restate the basic principles first articulated by the Task Force:

a) The owner has a clear contractual right to prepay and to use the property for other purposes unless prohibited by previous contracts. (Rent supplement, Flexible Subsidy, etc.)

b) Low and moderate income tenants residing in projects whose owners elect to prepay should be provided affordable shelter of at least comparable equality and cost.

c) Existing tenants should be permitted to remain in place with no increase in rental cost to the tenant, except for regulatory reasons, until adequate replacement housing is made available.

d) The Federal Government should provide necessary tenant based rental subsidy for such tenants and to ensure that sufficient low and moderate income housing continues to be available to meet the community's needs.

III. INCENTIVES TO OWNERS

The challenge facing us today is to develop sufficient incentives which will convince most owners to voluntarily agree to maintain their projects in the low income housing inventory without unnecessarily spending scarce resources by providing financial incentives to owners of projects whose best and highest use is subsidized housing.

The Tax Reform Act of 1986, in my opinion, broke a covenant made by the government to attract investment in low income housing on the basis that the below market rates of return would be offset by special tax advantages available to low income housing. The Tax Reform Act should be amended to correct this iniquity -

1) Financial Incentives

One attractive incentive to owners is the ability to obtain equity loans under the provisions of Section 241(f) of the National Housing Act. To make this provision effective, however, we recommend that the Secretary upon making findings similiar to those listed in paragraphs (1)(2) and (3)(A) through (3)(E) of Section 225(b) of the Housing and Community Development Act of 1987 be authorized to enter into a new Regulatory Agreement and to approve rents determined as follows:

a) For BMIR projects - rent equal to the lesser of fair market rents for comparable housing under Section 8(b) of the United States Housing Act of 1987 or 25% of the maximum income of a family for admission to that size unit. Such a formula will allow owners to attract tenants who can afford to pay such rents within a reasonable band of eligibility.

b) For 236 Projects - Market rents not to exceed fair market rents for comparable housing under Section 8(b) of the United States Housing Act of 1987 or 25% of maximum income of a family eligible for admission to that size unit. Basic rents would be established from market rents at levels which would reflect interest reduction assistance under the 236 contract.

It is further recommended that the Congress provide the Secretary necessary resources to fully implement these and other incentives authorized under Section 224 of the National Housing Act of 1987.

2) Tax Incentives

Since the issuance of various IRS regulations implementing the Tax Reform Act of 1986, it is apparent that tax code amendments are essential for the preservation of low income housing. Even the financial incentives discussed above will have limited value without such amendments. Some accountants for instance, question the interest deductibility of equity loans. We recommend the following proposals:

a) Exclusion from Passive Loss Limitation.
All losses resulting from operation of qualified low income housing from passive loss limitation.

b) Re-establishment of Depreciable Tax Basis.
The owner of an eligible low income housing project who voluntarily agrees to extend low income affordability restrictions for the remainder of the mortgage term pursuant to an agreement resulting from an approved plan of action should be permitted to re-establish the depreciable tax basis of the project at an amount based by the project's appraised market value at its best and highest use.

Such a provision is be essential to avoid taxes on "Phantom Income" accruing to owners who agree to keep their units in the low income inventory. "Phantom Income" occurs when the sum of principal payments and net payments to Replacement Reserve exceeds remaining depreciation allowances. This phenomenon usually occurs between the 17th to 22nd year of the mortgage. In the case of 236 projects, this condition is further exacerbated in the 27th to 29th year when the 236 subsidy paid as "interest reduction payment" exceeds the interest due under the mortgage and the excess is applied to principal payments.

Restoration of the depreciable basis will offset this phenomenon which was not clearly anticipated by the drafters of the program since it was expected that the projects would be sold under the then existing provisions of the tax laws after being held for 12 to 15 years.

If an owner were to sell his/her project to another entity this new entity would be able to start a new depreciation schedule based on the acquisition price. We propose that the owner who continues to own his/her project and signs a new lock-in agreement receive the same benefit.

c) Non-Taxable Transfer to Public or Non-Profit Entity Ownership or to Tenant Cooperative.

The transfer of a limited dividend or profit motivated eligible low income housing project to a qualified non-profit organization or public entity or tenant cooperative should be treated as a non-taxable event if:

i) the transfer takes place prior to mortgage prepayment; and

ii) the qualified non-profit or public entity agrees to continue operate the housing for the benefit of lower income families or persons and very low income families or persons without subsequent transfer for a period of time equal at least to the remaining term of the mortgage; and

iii) the only consideration for the transfer is assumption by the qualified non-profit or public entity of the existing debt secured by the mortgage and assumption of the obligations under the regulatory agreement.

d) Sale of an Eligible Low Income Project to Qualified Purchaser

The net tax liability incurred upon the sale of a limited dividend or profit motivated eligible low income housing project to a qualified purchaser shall be payable in five equal yearly installments if

i) the qualified purchaser agrees to assume the sellers obligation under the terms of the mortgage and Regulatory Agreement; and

ii) the qualified purchaser agrees to continue to operate the housing as low income housing under the terms of the Regulatory Agreement for the balance of the term of the mortgage.

e) Tax Free Exchange of Appreciated Property

The owner of an eligible low income housing project should be authorized to enter into a non-taxable exchange a non-taxable with a state or local public agency or qualified non-profit for another project or vacant land under the following conditions:

i) The owner's basis in the eligible low income housing to be exchanged would be re-established based on value established by the Secretary on the basis of its highest and best use.

ii) The public agency or qualified non-profit would agree to operate the project subject to the terms of the existing note and Regulatory Agreement for a period of time equal, at least, to the term of the mortgage.

iii) The owner would agree to either rehabilitate the property received in exchange or build new low income housing on the land received in exchange under the terms of such federal, state or local housing programs for the benefit of low or moderate income families available at the time of the exchange.

3) Low Interest Loans for Capital Improvements

The Federal Government should establish a revolving loan fund from which the owner of a low income project, requiring repairs or replacement of major components or the modernization of units could be permitted to borrow the necessary amounts at below market interest if

i) The owner has not requested or received other financial incentives.

ii) Such loan could be amortized over a period of time; principal payments and below market interest rate would be compatible with the cash flow of the project and acceptable to the Secretary.

Finally, we urge that the Congress simplify the legislative requirements of Title II of Housing and Community Development Act of 1987 and delegate appropriate authority to the Secretary to issue regulations to carry out the intent of the Act. The Secretary should also amend existing regulations to simplify the preparation of a proposal requesting incentives to continue the lock-in period during which the project will be operated for the benefit of low income families. Many owners of small eligible low income housing projects are frustrated by the complexity of the process. Most would welcome simple instructions to enable them to prepare and submit a proposal requesting incentives without having to retain the services of consultants or specialized legal counsel.

TESTIMONY OF CHARLES L. EDSON

BEFORE THE

HOUSING AND COMMUNITY DEVELOPMENT SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JUNE 20, 1989

My name is Charles L. Edson, a partner in the law firm of Kelley Drye & Warren. I am counsel to several organizations extremely concerned with the prepayment and preservation issue, namely, the National Leased Housing Association and the Assisted Housing Legal Rights Fund. I do not speak on their behalf as a formal matter, but I am authorized to say that my views generally reflect the thinking of those organizations.

Let me state at the outset that with the strong support of the Assisted Housing Legal Rights Fund, I am representing two plaintiffs who are challenging the constitutionality of the Emergency Low Income Housing Preservation Act of 1987 (ELIHPA) insofar as it diminishes the rights of the owner to prepay their notes after twenty years. These cases are now pending in the United States Claims Court and in the Eastern District of North Carolina. It is not my intent to discuss the legal challenges here. However, it is our strong contention that the government must punctiliously honor the letter of its agreement with project owners and for that reason the solutions that we are forwarding today should be voluntary on the part of the owner.

Even if not legally required, the owner's right should be honored both as a moral and practical matter. Morally, the government, like any party, just should not renege on its agreements. It is not the way that you and I act personally, nor is it the way that our great government should treat people who enter into agreements with it in good faith.

As a practical matter, the government cannot meet our low income housing needs alone; it is highly dependent on leveraging its resources with that of the private sector. We all know the emphasis being placed on private public partnerships. How can we realistically expect continued private participation in federal housing programs when the government does not honor its commitments to its partners.

It is no exaggeration to say that many key private participants viewed the moratorium on prepayment set forth in the 1987 Act with the gravest possible concern, especially since it followed the retroactive stripping away in the 1986 Tax Reform

Act of the right to take passive losses on real property. The voluntary solutions we propose will go far in restoring the faith of the private community in the word of the government.

As will been seen when we develop our proposal, even though voluntary, we are forwarding a suggested solution to this problem that is both fair to the owners who choose to participate and in all events protects the tenants residing in the low income projects.

Framework of Solution

Upon the expiration of the 20-year lock-in, HUD would offer the owner the opportunity to enter into a 20-year Preservation Contract. The contract would have the following key provisions:

1. Owners would have the right to charge any tenant in the project rent equal to 30% of income, the now-accepted rent-to-income affordability ratio under all federal programs. Indeed, it is anomalous that today in many Section 221(d)(3) projects some tenants are paying as low as 10%-12% of income for rent, whereas current programs now require the 30% ratio for very low income tenants in Section 8 projects. As under ELIHPA, if the tenant would face a rent increase greater than 30% to reach the 30% rent-to-income ratio, the rent increase would be phased in over three years. Otherwise, the rent increase would not be higher than 10% per year.

2. The owner would be required to rent apartments in the property to low, very low and moderate income tenants in the same ratio that those tenants were in occupancy on January 1, 1989, unless HUD and the owner agree on some other ratio of creating an economic mix. In that regard, there would be real advantages to all concerned if a Section 221 (d)(3) or 236 project had a meaningful portion of market rate tenants.

3. For those tenants whose payments at the 30% rent-income ratio would not equal the HUD fair market rent for the specific area involved, HUD would make available Section 8 existing certificates to bridge that gap. In other words, either through the tenant's own financial ability at the 30% rent-to-income ratio, or through the Section 8 existing certificates, the owner would be assured of obtaining a Section 8 existing fair market rent for the specific project area involved. (Of course, to the extent that the owner is the beneficiary of a below market 3% or 1% loan, then the Section 8 existing rents would be reduced to reflect that lower interest payment.) The fair market rent mechanism is useful because it is familiar to the housing community, and fair market rents, if properly tailored to specific project areas, are a good reflection of market value.

4. Any limitations imposed on distributions to the owner would be removed. In effect, then, the owner would be operating this project with market discipline. It would be receiving market rents through the mechanism set forth above, and could expect a market return assuming proper project management.

5. At the end of the 20-year Section 8 Preservation Contract term, the government has the option - but not the obligation - to buy the property for a price equal to the final year's total Section 8 Fair Market Rents capitalized at 10%. Accordingly, there will be a clear understanding now of what happens at the end of 20 years so that today's experience will not be repeated. Further, an owner with the incentive of a possible government buy-out would maintain the project in the best possible condition.

Voluntary Participation and Tenant Protection

In addition to the fact that the voluntary nature of this plan is both constitutionally and morally required, we believe it has many programmatic advantages:

First, the relatively few owners who do not choose to participate will have properties of very high value where it is uneconomic to retain them in the low income housing stock in any event. We believe that these would be relatively few cases - the Section 236 project overlooking Boston Harbor, Central Park or San Francisco Bay. Otherwise, the appropriate Fair Market Rent for the area involved should be more enticing to the owner than prepaying.

Secondly, it perhaps would be a good object lesson if some owners declined to take advantage of the Preservation Contract, converted the project to market rate or condominiums, and fell flat on their faces. These examples could only serve to induce more owners to participate in the program.

What about the tenants in those projects where the owner does not choose to enter into a preservation contract? There seem a number of solutions, either alternatively or cumulatively:

(a) The tenant would receive a Section 8 voucher and relocation expenses from the government, equivalent to those provided under the Uniform Relocation Act.

(b) The program structure might require the owner to permit the low income tenant to remain in occupancy for a specific period, such as up to five years at a rent equal to 30% of family income.

(c) The program could provide funds for the government to acquire the property through eminent domain at fair market value if HUD believes it is essential that a particular project be retained in low income inventory. This would be analogous to the non-profit buyout provided in ELIHPA for the pre-1979 Section 515 projects. We believe that such power would be exercised very rarely as refusals to participate would only take place where the fair market value of the property for conventional housing far exceeds that which could be obtained by capitalizing the preservation rents.

Preemption of State Laws

As evidenced by today's session, much serious thought and attention on the behalf of Members of Congress, HUD and the Administration, and the entire housing community are being harnessed and focused to solving the preservation problem. We are all here today seeking to balance the owner's legal and moral rights with the real needs of tenants who wish to stay in their housing and localities who want to preserve their low income housing stock. We hope to reach a solution fair to all. Once this solution is reached, then it should be allowed to prevail and not be hampered by state or local laws seeking to impose different, and often more burdensome, requirements on the owners. Such laws, either on the books or now being contemplated, include long and vague rights of first refusals, continued rent control and prevention of condominium conversions and other onerous sanctions including criminal penalties upon owners. Certainly, under the Supremacy Clause, the Congress can protect the solutions it has developed after such great thought and commitment.

Ascertaining the Cost

Bottom line, the solution here, like every other legislative solution in the present year, will be cost-driven.

I have no resources available to make an independent cost determination. However, cost estimates were set forth in last year's report of the National Low Income Preservation Commission. First, the Commission estimated that 243,000 Section 236 or 221(d)(3) units are likely to prepay within the next 15 years. The Commission also ascertained that the discounted cost of a 15-year voucher would be $30,000. The cost of our 20-year preservation contract would be less than an additional 25% or $40,000. The Commission estimates that utilizing a mechanism similar to our Preservation Contract concept, about 218,000 of the 243,000 units could be deterred from prepaying. Thus, there would be an $8.72 billion gross cost involved. However, the Commission estimates that $3.1 billion of this cost is to provide payments previously granted under Section 8 or 236, so the additional cost under the scenario would only be about $5.62 billion over a 20-year period.

However, we believe that this cost estimate is higher than the reality will be, because it assumes that every tenant in these projects will need Section 8 assistance. Our experience shows that this is not the case. As we stressed before, many Section 221(d)(3) and Section 236 tenants are paying a very small percentage of their income for rent. If their rent-to-income ratio was increased to 30%, we would imagine that the $5.62 billion figure would be significantly reduced, possibly by a third. Further, the Fair Market Rent payable under the certificate would be reduced to reflect the 1% or 3% interest paid by the owner on the Section 221(d)(3) or Section 236 loan. Of course, the cost would be increased by the need to provide voucher assistance for those 25,000 tenants who would be in the projects that would not enter into the Preservation Contract or to provide for the purchase of these projects under the eminent domain concept outlined above. However, because the non-participating projects probably would be few in number, the cost would be relatively small.

In conclusion, we have forwarded a preservation plan that protects tenants' rights, is fair to the owner, and does not place undue financial burdens on the federal government. Of course, in conjunction with the clients that I represent, I would be pleased to work with you and your able staff to fashion these proposals into legislation that hopefully will soon become law.

Thank you for permitting me to share my thoughts with you today.

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M E M O R A N D U M

May 19, 1989

TO: Senator Alan Cranston, Chair
Senate Housing Subcommittee

FROM: James R. Grow, National Housing Law Project

RE: Recommendations for Future Legislation to Preserve Existing Subsidized Housing

RECOMMENDATIONS FOR FUTURE LEGISLATION TO PRESERVE EXISTING SUBSIDIZED HOUSING

I. Termination of Affordability Restrictions on Subsidized Insured Projects by Prepayment or Voluntary Termination

Cover All Terminations by Any Means. Because affordability restrictions on successful subsidized projects may be terminated either by prepayment or by voluntary termination of the mortgage insurance, any permanent legislation must specifically cover both in order to provide a comprehensive solution. Although the language of the Emergency Preservation Act arguably covers voluntary insurance terminations as well as prepayments, future legislation must specifically clarify this coverage since both owners and HUD are taking contrary positions. See, e.g., Johnson v. HUD, Civ. No. 88-2293-C-5 (E.D. Mo. filed Nov. 28, 1988). This can be accomplished in either of two ways: (1) amend Section 229 of the National Housing Act to delete the voluntary termination option while establishing restrictions on prepayments, or (2) amend Sec-tion 229 to require any HUD approval for insurance termination to follow the same procedures and standards as those established for prepayments. Any revision should be specifically described as declarative of existing law.

Covered Projects. Any subsidized project that had not terminated its affordability restrictions as of November 1, 1987, should be covered.

Number of Units. Permanent legislation must seek to preserve for future use by very low-income tenants the maximum number of units possible, but at least the number of units occupied by very low-income tenants on January 1, 1987, or 50 percent of the units in a project, whichever is greater. A base date is necessary because once owners learn of pending legislation, they may seek to rent units only to higher-income eligible families. The January 1, 1987, date was used in the Preservation Act. HUD and owners must be required to preserve occupancy data for each project. The 50-percent minimum threshold is necessary because many owners have utilized tenant selection policies that exclude many very low-income families, particularly during the several years prior to anticipated conversion. HUD has also taken the position that the Preservation Act does not allow an owner to increase the percentage of very low-income Section 8 tenants in order to improve project cash flow. Most of the projects on which we have information that have sought to convert between 1987 and 1989 have very low-income tenants occupying only between 35 and 50 percent of the units, despite extraordinarily high area median incomes. While a compelling case could be made for using all of these units for very low-income tenants, it is more important to subsidize adequately those units that are preserved (see infra) so they remain affordable for the life of the project. The remaining units should be preserved for low-income tenants.

There should be no displacement of any eligible tenant, except those who choose to leave when rents are increased to 30 percent

Long-term Ownership/Length of Use Restrictions. It is absolutely critical that this legislation actively facilitate the conversion of for-profit owned subsidized housing to nonprofit and public ownership and establish perpetual, not time-limited, use restrictions. The legislation should not provide generous financial incentives to private owners in exchange for their agreement to lock in the use of the project for only the remaining term of the mortgage, because that exchange will simply defer the problem for 20 years and expend scarce federal financial resources to cover the owners' capital costs. Owners should not be able to obtain market-level returns and retain ownership of the property, only to cash in inflated equity paid for by the federal government and tenant rents once again 20 years from now. This is one of the fundamental problems with the legislation addressing FmHA prepayments and it should not be repeated. The units should be impressed with a perpetual use restriction in exchange for the provision of incentives.

Congress should provide nonprofit and public agency purchasers with capital grants to acquire threatened projects. The amount of the grant should be sufficient to permit acquisition after assumption of the existing loan and obtaining additional secondary financing with any cash flow from the Section 8 contract or from increased rents on the non-very low-income units. Over the long run, this is cheaper than providing the higher rent subsidies that would be necessary in order to pay off the debt service on any insured interest-bearing financing, and requires less in total budget authority. Certainly, a capital grant approach requires less budget authority than that which would be necessary for a combination of direct interest-bearing loans and subsidies necessary to keep those units affordable.

Congress must appropriate sufficient funds to make preservation work, while creatively using funds already appropriated. Funds for these capital grants and rent subsidies for the very low-income units could come from the recapture of interest-reduction payments on any units that will be allowed to float to market rent levels. In addition, funds can also be reallocated from the voucher program that is presently being used to assist very low-income tenants facing displacement by prepayment or Section 8 opt-outs. Presently, these voucher subsidies are approximately $5,000 per unit per year. If those subsidies were appropriated for contract terms of longer than five years, their cost would exceed the cost of the project-based subsidies required here because, here, changing ownership maintains the utility of cost-based contract rent formulas, rather than the market-based contract rent formula required with profit-motivated ownership. In addition, the project-based subsidies for most of these units will be cheaper than portable subsidies because, according to National Low-Income Housing Preservation Commission data, 85 percent of the existing subsidized stock would bear a market rent less than or equal to the fair market rents governing HUD's portable subsidy programs.

Other sources of funds to bridge the equity gap include: increased rental income obtained by removing the HUD "market rent" and 120 percent BMIR rent ceilings, the low-income housing tax credit and other modifications to the tax laws affecting capital gains.

An essential part of this effort must include resources to develop the capacity of nonprofit organizations and public agencies to acquire threatened projects. This should include not only the direct financial assistance necessary to permit acquisition just described, but also technical assistance and pre-development loans. In the long run, these expenses will prove negligible when compared to the benefits of removing subsidized housing from the speculative market.

Nonprofit organizations and public agencies should be permitted preemptive rights to purchase projects beginning several years prior to the point of conversion. Alternatively, the legislation must clearly establish transfers to such entities as more financially beneficial to owners than continuing to hold the property or transferring it to another for-profit owner. For example, access to insured secondary financing could be restricted to public agency and nonprofit purchasers. These purchasers should be permitted to join together with existing owners to submit plans of action, and these plans and transfers (together with the financial resources necessary to consummate them) should be possible far in advance of any threatened conversion, because it will be much less costly to transfer these properties earlier.

Establishing Value to Be Paid to Owners. This is a difficult area because it pits Congress' desire to conserve scarce subsidy funds against the owners' demand to receive fair market value. The legal constraints on Congress' ability to regulate the owners are uncertain. Several options are available: (1) pay owners the appraised fair market value; (2) pay owners the value of their equity after increasing the rents to true market rents, but imposing a cap at the Section 8 Existing FMRs; (3) pay owners a reasonable return on their investment; or (4) pay owners a value based on continued or modified use restrictions. Congress must choose an option that is at the same time politically acceptable, that minimizes legal risks, that maximizes the number of units retained for very low-income use, and that can be fairly and consistently administered.

Future Tenant Eligibility for Vacancies. For the units that are set aside for very low-income people, and that are deeply subsidized, there must be no discrimination based upon the amount or source of the tenant's income. For the other units, similar discrimination should also be prohibited, so long as the tenant has a history of paying rent at similar amounts or has a portable rent subsidy that enables payment of the market level rent. For any units where the tenant's share of the rent is below market, owners should be required to follow federal waiting list and tenant selec-

tion standards, and HUD should actively oversee the admissions process.

Fair Housing Objectives. These units provide an enormous resource for furthering federal fair housing objectives because they are often in above-average condition and located in markets experiencing gentrification and resegregation. Because termination of affordability restrictions would diminish fair housing opportunities for non-white very low-income families, and because portable subsidies are probably both least successful and most expensive in these same submarkets, the nation's fair housing policies require preserving a significant number of these units. In addition, administrative mechanisms must be put in place to ensure that these opportunities are in fact made available to poor nonwhites.

Rehabilitation Needs. Since these projects are 20 years old, some of them will require modest rehabilitation. For those units that are to be preserved for very low-income families, the federal government has the option of funding this rehabilitation through a grant program, or through higher operating subsidies that would permit rehabilitation costs to be included in any secondary financing.

Tax Modifications. A significant off-budget subsidy to facilitate nonprofit transfers could be created by forgiving capital gains taxes otherwise paid by for-profit owners who sell a project to a qualified nonprofit or public agency purchaser that commits to permanent use restrictions. See, e.g., Cal. Rev. & Tax Code § 18035.5. A small portion of the benefit derived from this forgiveness could be allocated to the seller to encourage the sale to a nonprofit.

Approval Standard and Procedures. Prepayment requests should still be subject to HUD approval under standards very similar to those in the Preservation Act. Owners who cannot meet this standard should then be required to transfer the project to a qualified nonprofit or public agency purchaser, including regional or national organizations. Should there be no such purchaser, then the owner should be permitted certain incentives, including rent adjustments on the non-very low-income units, and rent adjustments and subsidies on the very low-income units, subject to the preemptive rights being exercised subsequently by an eligible purchaser. An appraisal process can ensure that only those projects capable of conversion receive additional returns.

The procedures contained in the Preservation Act should be revised to require an owner to submit a notice of intent to prepay not only to HUD, but also to tenants of the project and any nonprofit or public agency purchaser that has notified HUD of its desire to receive such notices. A brief summary of the plan of action should also be submitted to these individuals and organizations, and the entire plan should be made available to them upon request.

HUD should engage in longer-range planning for the future of these projects, including not only the gathering and dissemination of information on projects likely to be threatened, but also actively working with tenants, nonprofits and local governments significantly in advance of conversion to facilitate the orderly transfer of property.

II. Section 8 Opt-outs and Contract Expirations

The Emergency Preservation Act requires owners who plan to terminate their Section 8 contract to give a one-year notice to HUD and the tenants. HUD is then obligated to adjust the contract rents upward to a reasonable market rent within the Section 8 Existing Housing FMRs (or according to legislative history, 120 percent of this amount). It is questionable whether HUD is fulfilling this obligation. But, even if HUD were actively offering owners rent adjustments, owners are not obligated to accept them under the terms of the Preservation Act. These rent adjustments make sense because, even after adjustment, the subsidies paid are probably less than those that would be paid on behalf of tenants under any replacement portable subsidy program, and displacement is avoided.

This statutory structure can be improved by three revisions. First, in the short run, owners should be obligated to accept a renewal of the contract at the adjusted market rent level. Because market rents are being paid under the subsidy program, owners have no claim that their economic interests are not being protected. Second, over the long run, nonprofits and public agencies should be given preemptive rights to purchase these projects and assume the Section 8 contracts. Because the Section 8 contract rents after adjustment will approximate the true market value of the units, purchasing entities can carry the debt service required for new financing in most cases. To reduce long-term subsidy costs, however, the federal government could make low-interest loans or grants available for this purpose. Some financing will be necessary if the Section 8 contract rents lag behind true market rents when the project is sold. Once projects are converted, rent adjustments can revert to a cost-based system. Third, HUD should have a duty to exceed the 120-percent standard if necessary to avoid the displacement of elderly handicapped tenants or to further fair housing objectives.

If the true market rent for the project exceeds the Section 8 Existing Housing FMR (or 120 percent of the FMR), and the owner is therefore relieved of an obligation to renew, the legislation should require owners to provide basic relocation assistance to displaced tenants, and HUD should provide Section 8 certificates for those tenants. Special anti-displacement protections should be built in for elderly and handicapped tenants.

JRG:kc

Low-Income Housing Preservation

Presented to the
United States Senate
Committee on Banking, Housing, and Urban Affairs
by
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on Behalf of the
National Council of State Housing Agencies

Introduction

The nation faces a period of crisis for low-income housing. The available supply is shrinking. A just-released 1989 report of the Joint Center for Housing Studies at Harvard University, "The State of the Nation's Housing," found that despite the near doubling of subsidized units from 1974 to 1985, the total number of occupied units renting at or below $300 per month fell by 1.7 million. The number of non-subsidized units renting for less than $300 fell by 2.8 million, a decline of nearly one-third.

Those 2 million low-income housing units which receive federal subsidy are the foundation of the nation's low-income housing stock. In the coming years, many of these units will be caught up in a national housing crisis. An estimated 348,500 units in projects with assisted mortgages eligible for prepayment could be converted from low-income use. Another 1,418,000 units with rental assistance face the expiration of this subsidy and further obligations by their owners to continue the units as low-income.

Section 8 New Construction and Substantial Rehabilitation assistance payments to 200,000 units will expire by 1995 and another 496,000 units will be affected by the year 2002. In each of these units, low-income people will face steep rent increases or be forced to move. A rough approximation of the cost of extending this assistance, based on a current annual cost of $5,000 per household, suggests that $1 billion will be needed in 1995 and $3 billion in 2002, without accounting for inflation.

Similarly, the cost of continuing rental assistance payments on FHA-insured projects which would otherwise convert from low-income to market rate use could total as much as $850 million in current costs. As many as 350,000 households in units now receiving $3,000 in subsidies each year could be affected.

Finally, almost 721,000 households receiving rental assistance under the Section 8 Existing program stand to lose this assistance during the next five years. The cost of renewing these subsidies is estimated at $29 billion.

Title II of the Emergency Low-Income Housing Preservation Act of 1987 concentrated on mortgage prepayment. Yet, expiring rental assistance represents a far greater problem. Should project-based rental assistance contracts not be renewed or portable rental assistance funding levels decline, the impact upon the low-income housing market will be devastating.

The Preservation Challenge

Over the last 20 years, the Federal government has assisted in the production of 2 million units of privately owned low-income rental housing. This housing, frequently referred to as the "federally-assisted inventory," represents an important housing resource at a time when the overall supply of rental housing affordable to low-income Americans is diminishing. Yet, during the next five years, sizeable portions of this inventory may be lost.

In some cases, mortgages which include low-income use restrictions are becoming eligible for prepayment. Of 350,000 units, covered by such mortgages, it is estimated that 155,000 units could be lost due to prepayment. Contracts for federal rental assistance subsidies are also approaching termination. This problem confronts over 200,000 units over the next five years and another 496,000 by the end of the decade. When the rental assistance ends, rents will increase dramatically to cover operating and debt costs. The consequences for low-income tenants will be grave.

Finally, HUD holds mortgages on an estimated 10 percent of the assisted inventory and is in possession and must dispose of another three percent. This "distressed" portion of the inventory presents a significant financial challenge. Frequently, these projects harbor attendant social problems including drugs, unemployment, and crime.

HFA Stake In Preservation

As public agencies committed to the provision of low- and moderate-income housing, state housing finance agencies (HFAs) are concerned about the preservation of the existing stock. Through their national organization, the National Council of State Housing Agencies (NCSHA), HFAs have begun a systematic assessment of the 413,500 units which they managed or financed.

State HFAs financed 28 percent of the Section 8 New Construction and Substantial Rehabilitation units in the inventory and 19 percent of the Section 236 units. With the recent purchase of HUD's Section

221(d)(3) Below Market Interest Rate inventory, State HFAs control 29 percent of these units. State HFA capacity was recognized when this inventory was being created. Section 8 New Construction and Rehabilitation units were afforded a "fast-track" in HUD processing. The strength of HFA underwriting is evidenced in HFA portfolios which contain few troubled projects.

Through involvement in the financing or management of their inventories, State HFAs have the largest interest in this housing resource of any entity apart from the Department of Housing and Urban Development. Many of the units which could convert to market rate use upon mortgage prepayment or subsidy expiration or which are experiencing distress are of direct concern to State HFAs.

State HFAs' interests extend beyond their own mortgage or management portfolios, however. Any assisted units within a state are important to the HFA. The loss of these units will exacerbate already worsening affordable low-income housing shortages.

States Can Play a Strategic Role

State HFAs are strategically positioned to address the preservation problem. In partnership with the federal government, HFAs can identify at-risk projects and develop strategies to prevent their loss. Through their diverse housing experience, HFAs are aware of the resources needed to maintain low-income use.

State HFAs have worked with project developers and owners and are familiar with local market dynamics. HFAs can negotiate solutions with owners which consider economic realities and the needs of tenants. Federal resources which must be forthcoming can be channeled through the HFAs to affect these solutions.

Within the national housing policy that must be created on preservation, State HFAs should be given responsibility for:

- Assessing the magnitude and nature of the problem in their states;
- Quantifying costs and identifying resources;
- Devising a strategy for preservation within the context of overall state housing needs; and
- Working out at-risk projects within a framework established by Congress and HUD.

State HFAs are well positioned to consider the multiple interests at stake: the owners', the tenants' and the public sector's. Moreover, state HFAs have experience to draw upon, are familiar with the projects (many of which are owned or were financed by HFAs), and are aware of their state's housing need.

Federal Support is Essential

The ability of states to play this expansive role will depend upon the response of the federal government.

- Congress must provide substantial resources. The cost is too large to be borne by the states.
- HUD must provide a positive regulatory and administrative framework that facilitates the combination of project resources with federal and other resources which states identify as needed.
- HFAs should be delegated responsibility to negotiate and consummate agreements to extend low-income use within HUD's framework.

HUD's Essential Role

It is important to recognize how HUD policies contribute to the preservation problem.

- The Section 8 rent comparability standards HUD is imposing may result in the deteriorating physical and fiscal health of many projects and limit the desire of owners to remain in the program.
  - In circumstances where no truly comparable rents are present, current comparability requirements can unduly penalize a project and jeopardize its continued viability.
  - HUD comparability standards fail to consider the special housing needs of populations served by the projects -- elderly, large families, and physically disabled -- in the required comparison with projects serving the general population.
  - Comparability guidelines do not provide for sufficient funding of reserves for future repairs and replacements.
- Changes in the Flexible Subsidy program (interim rule 24 CFR Part 219) will limit its usefulness as a means of addressing distressed and aging projects.

- Non-insured mortgages which State HFAs have financed should be afforded equal treatment in the allocation of Flexible Subsidy funds as FHA insured projects.

- Raising owner contribution requirements to a minimum of 30 percent of cash for operating assistance and capital improvement loans places too great a burden on projects needing this assistance. The HUD waiver provision should be applied equally to non-insured loans.

- Various provisions governing cash contributions, treatment of reserves and capital improvement loans for non-insured projects will thwart owners' efforts to maintain the projects' fiscal and physical quality.

- Application and operating procedures should be made more flexible (for example, by not requiring plans and specifications, and bids at the application stage) so that states can more efficiently use the Flexible Subsidy programs in dealing with distressed and aging portfolios.

• Budget authority for rental assistance is insufficient for projects with 20 to 40 year rental assistance contracts.

- Congress should assure full funding for these contracts.

- Project reserves should not be used to fund contract shortfalls.

- Project accounts should be maintained at the 40 percent level stated in the annual contract commitment.

• Current HUD management of Section 8 contracts can counteract preservation initiatives.

- Substitution of cancelled Section 8 contracts with vouchers results in the loss of needed project-based subsidies which could be transferred to other projects in the community.

- With post-1981 HAP contracts, HUD should encourage the approval of increased returns on equity.

• The creation of an Office of Preservation in HUD is essential both to HUD's oversight responsibilities and as a clearinghouse facility.

- The office could respond to requests for information, such as appraisals of Transfers of Physical Assets.

- Upon receipt of a Request to Prepay by an owner, the office should be required to notify the affected state HFA.

Incentives and Resources Should be Tailored to the Problems

One of the most confounding aspects of the preservation problem is that no single solution is apparent. Each project facing disposition and conversion to market rate use must be treated on a case-by-case basis.

Projects Subject to Mortgage Prepayment

Two approaches can be taken when projects are identified as at risk of mortgage prepayment and conversion to market rate use.

- To encourage owners not to prepay, negotiations will be needed, backed by appropriate resources, including:

  - Increases in allowable distributions -- equity should be calculated to equal appraised value less the mortgage balance with distribution equal to the balance times 6 percent;

  - HUD should facilitate secondary financing to release equity, with the amount of financing to be based on value and debt coverage. The amount could be limited to $15,000 per unit or the amount of debt service generated from rents set at 30 percent of 80 percent of area median income;

  - The Section 236 project Fair Market Rents (FMRs) should be raised to the level of Section 8 Existing FMRs and should allow 30 percent of income to be paid for housing;

  - The depreciable tax basis should be re-established with depreciable basis equal to appraised value; (if owners are willing to "lock-in" until mortgage maturity, they would be allowed to use 65 percent tax losses to offset other income) and

  - A capital improvement program should be created at a greater funding level than currently proposed.

- Where prepayment is a certainty, resources should be present to facilitate disposition that continues low-income use, including:

- Non-taxable sale to non-profits, if a sale is made prior to prepayment and low-income use is continued. (A bargain sale structure or statutory waiver of tax on gain would be necessary.);

- A separate pool of Low-Income Housing Tax Credits targeted to preservation. (A Credit for acquisitions not involving rehabilitation, an allowance to increase the present value as needed, and the ability to use the Credit in bargain sales transactions would be necessary.); and

- Raising the Section 236 project Fair Market Rents (FMRs) to the level of Section 8 Existing FMRs.

Projects Facing Expiring Subsidies

Two types of problems are created by impending contract expirations on Section 8 projects:

- Projects which would otherwise remain as low-income, but need continued subsidies; and

- Projects whose owners want to convert to market use at the end of the Section 8 contract period.

The response is different for each problem:

- Assistance for projects needing continued subsidies should be provided and can include:

  - Project based rental assistance -- vouchers are not the answer -- with a term equal to the remaining mortgage term; and

  - Loan Management Set-Aside contracts extended to mortgage maturity. (In addition, any recaptured LMSA authority should be recycled.)

- Projects whose owners desire to convert to market rate use should be treated in the same manner as those whose owners desire to prepay.

Distressed Projects and Aging Inventory

Foreclosed HUD insured, HFA financed projects, as well as projects with significant repair and upgrading needs resulting from aging should be the focus of HFAs and the federal government.

- Two types of issues are involved:
  - Economic and physical condition of the project; and
  - Social problems -- for example, drugs and unemployment.
- The response requires three types of resources:
  - Operating assistance and capital needs subsidies, such as an Operating Assistance Loan and Capital Improvement Loan Program;
  - Social services assistance;
  - A separate Low-Income Tax Credit pool for acquisitions to facilitate workout/salvage negotiations; and
  - Extension of Section 8 Contracts to cover new debt service.
- To facilitate the state role in addressing distressed projects and the aging inventory, the federal government should:
  - Allow states to control ownership and management following foreclosure as in the 1987 federal housing act's Demonstration Program;
  - Create a pilot program for states to assist in addressing the real estate owned (REO) problem in federal agency portfolios; and
  - Allocate more funds to Flexible Subsidy Programs (both operating assistance as well as capital improvement).

Conclusion

State HFAs are strategically positioned to play a crucial role in preserving the assisted low-income housing inventory. There are certain basic tactics which states can employ using the incentives discussed above.

- Transfer the projects to nonprofit ownership . . . for those projects in which owners choose to prepay or opt-out of subsidy contracts.
- Allow owners access to project cash . . . to dissuade owners from prepaying or to fund needed project improvements.
- Increase owner's equity as a basis for calculating return . . . to dissuade owners from prepaying or to allow needed project improvements.
- Restructure the financing . . . to dissuade owners from prepaying or to allow needed project improvements.

To support these approaches, substantial new federal resources will be required in the form of renewed project-based rental assistance, additional Low-Income Housing Tax Credits, capital improvement loans and social services.

THE FEDERALLY ASSISTED LOW-INCOME HOUSING INVENTORY

	FY 1988 Commitments	State HFA	% State HFA
Public Housing	1,643,000	0	0%
Section 8 Existing/Vouchers	1,069,000	53,500	5.00%
Privately Owned Subsidized			
Section 8 New/Rehab	868,000	237,000	27.30%
§ 221(d)(3) BMIR	159,000	47,000	29.56%
With § 8 LMSA:	30,000		
Assisted § 221(d)(3) MR	80,000	Unk	
With § 8 LMSA:	72,000	Unk	
§ 236	406,000	76,000	18.72%
With § 8 LMSA:	180,000	Unk	
FmHA § 515 Rental Assistance	394,000	Unk	
Other	165,000	Unk	
Total	4,784,000	413,500	8.64%

The Need For Preservation	Units	Current Cost/Unit	Total Cost In Current $s
Section 8 New/Rehab	868,000		
Contract Expires 1995	200,000	$5,067	$1,013,400,000
Contract Expires 2002	496,000	$5,067	$2,513,232,000
§ 221(d)(3) BMIR	159,000		
With § 8 LMSA:	30,000	$3,013	
Mortgage Eligible to Prepay	94,400		$284,427,200
Assisted § 221(d)(3) MR	80,000		
With § 8 LMSA:	72,000	$3,013	
Mortgage Eligible to Prepay	19,500		$58,753,500
§ 236	406,000		
With § 8 LMSA:	180,000	$3,013	
Mortgage Eligible to Prepay	235,000		$542,340,000
Total	1,044,900		$4,412,152,700

Sources:

National Low-Income Housing Preservation Commission
National Council of State Housing Agencies
"Current Housing Problems and Possible Federal Responses" Congressional Budget Office

STATEMENT OF EMILY P. ACHTENBERG
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before the

SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

June 20, 1989

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GENERAL POLICY ISSUES

The subject of this hearing--the preservation of our privately-owned, federally-subsidized housing stock--is one that is of critical importance in Massachusetts today. Throughout the Commonwealth, there are some 26,000 units in projects whose subsidized mortgages are or will become eligible for prepayment in the coming years. In a state where the shortage of affordable housing has truly reached crisis proportions, the retention of these units is critical not only to avoid displacement of existing low and moderate income tenants, but to maintain the balanced population and workforce that is essential to the continued vitality of our economy and to the well-being of all Massachusetts residents.

For the past several years, I have been working with tenant organizations, community-based non-profit sponsors, and state and local government agencies on a variety of strategies to preserve this critical housing stock. Title II of the Housing and Community Development Act of 1987 has provided an initial framework of regulatory constraints and permissible incentives to shape these efforts--but it is clearly only an interim measure, which presents significant problems as well as opportunities. In developing a more viable and permanent legislative approach based on our experience with Title II, Congress will need to consider the following general policy issues:

Balancing of Preservation Costs

The existing statute sets forth a set of tenant protection and unit preservation standards which begin to establish the costs of retaining the current use of subsidized projects. However, it effectively begs the critical question of how these preservation costs should be allocated. A variety of preservation incentives are authorized but not mandated or specifically funded. Some potentially appropriate subsidy programs or other incentives have statutory, regulatory, or budgetary features that expressly or effectively preclude their use for preservation purposes. Moreover, while Title II authorizes the use of incentives to provide a "fair return" on the owner's investment, the absence of any standards to define this term has created a climate of uncertainty and conflicting expectations which has frustrated preservation efforts, especially in view of the statute's limited duration.

As a result, few Plans of Action have been submitted to HUD, and only one is known to have been approved. Most owners continue to expect compensation for the highest and best use value of their properties, while HUD has neither requested nor specifically allocated available subsidy funds for Title II incentives. Title II has operated, for the most part, to maintain the status quo--a result which will not facilitate the long-term viability and affordability of most prepayment-eligible projects. A more viable and permanent approach to the prepayment problem will require both targeted funding and a standard for reasonable equity compensation, consistent with the original and continuing social purpose of the housing, that allocates the costs of preservation in an equitable manner.

Facilitating Non-Profit Ownership

While the current statute pays lip service to the goal of facilitating the transfer of subsidized projects to limited-equity cooperative, non-profit, and/or public ownership, available preservation incentives are primarily geared towards retaining existing private ownership arrangements. Additionally, in the absence of extended prepayment restrictions or pre-emptive purchase rights, it

has been difficult for potential non-profit buyers to acquire projects at prices consistent with available subsidy resources, or even to bring owners to the negotiating table.

Unfortunately, this approach only serves to postpone the problem of market-rate conversion for another twenty years. Alternative ownership arrangements which are not motivated by expectations of residual gain would provide a far more cost-effective use of preservation incentives by facilitating the permanent retention of the projects as affordable housing. A number of tenant, non-profit, and publicly-sponsored preservation initiatives have been proposed in Massachusetts, Vermont, California, and other states which have a strong tradition of community-based housing development. New regulatory and incentive mechanisms will be required to encourage and expand these efforts.

State and Local Role

While Title II purports to encourage the involvement of state and local government agencies and tenant organizations in project preservation efforts, the procedures required to carry out this objective are less than adequate and have not been clarified by HUD's implementing regulations. The alternative state strategy provisions authorized by Title II are applicable only in limited circumstances, have not proved workable, and, to date, have not been implemented.

At the same time, states such as Massachusetts have committed substantial funds to support the preservation of Title II projects, especially through the transfer of ownership to tenant- and community-based non-profit organizations. These include deferred-payment operating subsidy loans, grants for weatherization improvements, public housing acquisition funds, low income housing tax credit and tax-exempt bond financing allocations, and loans to cover pre-development costs. Massachusetts has also played an active role in brokering, structuring, and tailoring preservation plans to the needs and circumstances of individual projects. Substantial financial commitments have also been made by the cities and towns in which these projects are located. Additional legislative changes will be required to facilitate these initiatives and to provide a more meaningful role to communities that make significant contributions to project preservation efforts.

LEGISLATIVE RECOMMENDATIONS

Within this general policy framework, the following specific revisions are proposed to Title II and related statutes affecting project preservation.

General Prepayment Limitation

Duration. An interim extension of Title II, which would merely perpetuate the climate of uncertainty created by the current statute, is problematic. Experience to date suggests that temporary regulatory measures have only a limited impact on property values, do not induce owners to participate in preservation efforts, and make it difficult for HUD and Congress to anticipate the level of funding required for incentives. At the same time, projects falling just outside the window of interim restrictions, whose preservation cost today will be less than in the future because of their extended lock-in periods, are not eligible for assistance.

Prepayment legislation should be permanent, or should at least provide adequate lead-time for preservation planning (e.g. 5 years). If only a short-term extension is feasible, an additional window should be provided for projects involving acquisition by tenant, community-based non-profit, or public entities, in order to facilitate and advantage these efforts.

Applicability. Recently some owners have sought to bypass Title II through voluntary mortgage insurance terminations. The legislation should be revised to clarify its applicability to these situations, with conforming amendments to Section 229 of the National Housing Act. Additionally, in order to clarify any ambiguity relative to the effective date of Act, which is currently the subject of litigation, the legislation should clearly reflect Congressional intent to cover any subsidized project that was subject to affordability restrictions as of November 1, 1987.

Enforcement. Both the existing statute and HUD's implementing regulations are unclear as to what remedies should be pursued in the event of an unauthorized prepayment. To clarify Congressional intent in this regard, the legislation should direct HUD to order a recission of the prepayment in these situations.

Criteria for Approval of Plans of Action Including Incentives

Tenant Protection. Where incentives are included in a Plan of Action, Title II limits allowable rent increases for current tenants to 30% of adjusted income or the Fair Market Rent (whichever is less). It further provides for a phase-in of resulting rent increases under certain conditions, **except** for increases attributable to operating costs. The legislation is unclear as to whether rent increases for current tenants after the phase-in period are to be based on incomes or on operating costs.

Many lower and moderate income tenants will experience substantial increases as their rents are phased-in from current below-market levels to 30% of adjusted income. In the absence of an income-based rent ceiling, these tenants will have no protection against a future decline in income due to job loss, disability, change in family composition, etc. In order to avoid undue hardship, the legislation should be revised to clarify that rents for current tenants may not exceed 30% of adjusted income (subject to FMR limits) for the remaining term of their tenancies. Since non subsidy-eligible tenant incomes will generally rise sufficiently to cover costs, while rental subsidies will absorb cost increases for very low income units, this approach should not impose an unfair preservation cost burden on owners.

Unit Preservation. Upon turnover, Title II requires the preservation of all units occupied on January 1, 1987 by very low, lower, and moderate income tenants for the same income groups, "to the extent practicable." HUD currently interprets this provision to preclude any increase in affordability across income tiers, e.g. by leasing available units to Section 8 certificate- or voucher-holders. This position is clearly contrary to Congressional intent and other statutory provisions prohibiting discrimination against households with Section 8 subsidies.

The legislation should be revised to clarify that Congress' objective is to prevent any **reduction** of existing affordability and to encourage the provision of more affordable units. Over time, a minimum of 20% of the project units

should be made available and affordable to very low income tenants, to the extent feasible. For projects where fewer than 20% of the units currently receive rental subsidies, this standard could be achieved through the preferential marketing of turnover units to Section 8 certificate- or voucher-holders.

Additionally, existing statutory language should be modified to clarify the rent structure required for turnover units. Currently, turnover rents can be geared to affordability at the top of the relevant income tier, with no market limit; and it is unclear whether operating cost increases can be passed through on top of this maximum. In Boston, this means that a 2 BR unit in the moderate income tier could arguably be rented upon turnover for $1,010 (30% x $40,400, the applicable BMIR limit for a 4-person family)—plus operating cost pass-throughs. If limited to the FMR ($803), this unit would be available to a household earning $32,120, or 71% of the area median income. New legislation should cap turnover rents at 30% of the incoming tenant's adjusted income, or the FMR (whichever is less), for the duration of the restricted use period. (This approach is preferable to HUD's current practice of prescribing a multi-layered rent structure for turnover units within each tier in order to serve a range of income groups, which is administratively unworkable.)

Equity Compensation. For the reasons outlined above, new legislation should define the "fair rate of return on investment" that is supportable through available incentives. This will require an approach to equity compensation that takes into account both the opportunities and the limitations imposed by current market realities, that fairly rewards owners' legitimate investment-backed expectations while excluding consideration of value attributable to changed economic circumstances and housing scarcity conditions, and that balances the Government's contractual obligation to existing owners with the original and continuing social purpose of the housing. As well, standards for equity compensation should be designed to facilitate the transfer of projects to alternative ownership arrangements that will maximize the long-term public benefit of incentives provided.

One possible approach would be a formula reflecting the owner's inflation-adjusted investment in the property, plus capital gains tax liability (if applicable). This concept is similar to the Mitchell-Danforth Task Force's recent proposal for the buyout of low income housing tax credit projects. The adjusted equity would be the original cash equity actually invested in the project plus any additional contributions documented through cost certification, multiplied by the applicable increase in the Consumer Price Index for the metropolitan area (capped at 5% per year). In no case should the level of equity compensation supported by incentives exceed the current market value of the owner's equity, as determined by a highest and best use appraisal of the property.

Additionally, the formula could reflect some type of premium for projects being transferred to non-profit ownership. This would recognize that it is more cost-effective to the Government to effectively buy-out the residual value of projects today (at any level), than to continue to support private ownership arrangements requiring renewed incentives to preserve the housing after its restricted use period.

Incentives to Extend Lower Income Use

The development of a workable incentive program for existing owners and new purchasers of prepayment-eligible projects will require a combination of new legislative tools, statutory and regulatory changes to make existing incentives more workable, and funding set-asides for resources to be targeted specifically for preservation initiatives. For example:

Rental Subsidy. Experience suggests that many if not most prepayment-eligible projects will require additional rental subsidy to preserve their existing low income use. While Title II currently mandates the use of Section 8 assistance for eligible tenants in such projects, no funds have been authorized or appropriated for this purpose. In FY 1989, Congress appropriated funds for 1,300 "prepayment vouchers." However, these subsidies are currently available only in those limited instances where a subsidized mortgage is actually **prepaid,** and do not satisfy Title II's requirement for long-term unit preservation in any case.

As a result, preservation projects have been forced to compete with "troubled projects" and others requiring assistance for extremely scarce project-based subsidy resources. While Section 250(b) of the National Housing Act directs HUD to award Section 8 assistance **on a priority basis** to prevent the prepayment of subsidized mortgages, it is not clear how or whether this statutory mandate is being implemented. Moreover, HUD's recent Interim Rule implementing the new Section 8 project-based certificate program arbitrarily prohibits local PHAs from allocating this form of Section 8 to projects receiving Flexible Subsidy assistance, a critical tool required by many preservation projects (see below). The Section 8 statute should be revised to expressly authorize this use of project-based certificates; and a specific set-aside of project-based Section 8 subsidy should be established for Title II projects.

Rehabilitation Financing. Many prepayment-eligible projects have substantial rehabilitation and/or capital improvements needs. The primary source of financing for these projects is the Flexible Subsidy capital improvements loan program, which provides direct below-market interest rate loans on a priority basis to Title II projects. Currently the use of this program as a preservation tool has several problems.

First, while the statutory purpose of the Flexible Subsidy program has now been broadened to include preservation as well as operating assistance to troubled projects, available funding sources have not increased. In fact, in FY 1989 Congress reallocated $150 million in available Flexible Subsidy funds to other programs. In its current and previous budget request, HUD has proposed that Section 236 excess rental charges--the primary source of Flexible Subsidy funding--be diverted to the Treasury for general use. And while the Flexible Subsidy statute requires that 40% of available program funds must generally be allocated for capital improvements loans, primarily for Title II projects, it is not clear whether this mandate will be implemented because of the substantial backlog of troubled projects currently seeking operating assistance.

Congress should act to protect existing sources of Flexible Subsidy funding; to appropriate the additional funds required to meet the needs of both troubled projects and preservation projects; and to strengthen the existing

mandate for a preservation set-aside. Additionally, HUD should be directed to utilize excess rental income from the Section 221d3 BMIR program (which is currently retained in the project's surplus cash account) to fund the Flexible Subsidy program.

Changes to the Flexible Subsidy statute are also needed to allow capital improvements loans to be provided on a deferred basis, if necessary, similar to operating assistance loans. Many preservation projects—especially those being acquired by non-profit purchasers—will require Flexible Subsidy in the form of a deferred loan because they cannot service their rehabilitation debt from available project income within Title II rent constraints. Additionally, the capital improvements loan program should recognize operating deficits during the rent phase-in mandated by Title II as an eligible cost. (Alternatively, a set-aside of Flexible Subsidy operating assistance could be provided for preservation projects requiring more flexibility.)

Equity/ Acquisition Financing. Title II authorizes the provision of insurance for secondary financing under Section 241, to enable owners of eligible projects to recapture a portion of their residual equity while retaining the existing subsidized mortgage. This incentive is available to existing owners and also to new non-profit or limited-equity cooperative purchasers as a critical tool for acquisition financing.

Legislative revisions are needed to make this program more workable. First, Congress should authorize and direct HUD to implement a coinsurance program for equity loans, to expedite processing and facilitate the involvement of private lenders. Additionally, the required debt coverage ratio (net income in relation to debt service) should be reduced from the current standard of 1.11 to 1.05 where necessary for project feasibility, in order to increase the maximum loan amount that can be insured.

Some preservation plans involving the use of secondary financing may not require insured equity loans (e.g. where a housing finance agency is providing funds for a second mortgage). With respect to permissable incentives, Title II should be revised to authorize the servicing of this additional debt out of project income, whether or not its source is an insured equity loan.

Finally, legislative changes are needed to promote the use of creative techniques that reduce the cost of equity financing in preserving Title II projects. For example, one approach that has been proposed in Vermont would involve the use of below-market rate seller financing in conjunction with an installment sale transaction, through an interim purchase of the property by the housing finance agency which will issue tax-exempt bonds. This technique will enable the project to combine the benefits of reduced-rate equity financing with a lower overall acquisition cost, reflecting the deferral of taxes associated with the installment sale. Other housing finance agencies are seeking to purchase Title II projects on an interim basis in order to facilitate "bargain sales," enabling the difference between the acquisition price and the market value of the property to be claimed by the seller as a charitable contribution. Currently, the Section 236 statute presents an obstacle in this regard, since public entities do not qualify as eligible mortgagors for the program. The statute should be revised, consistent with Section 221 legislation, to remedy this problem.

Existing Mortgage Debt. HUD currently holds the mortgages on a substantial number of Title II properties, and will likely acquire many more in the future because of legislative provisions allowing 221d3 BMIR mortgagees to exercise an assignment option in the 20th year. This presents a significant opportunity for creative debt restructuring to facilitate the preservation of Title II projects, which is not currently being utilized.

For example, existing HUD-held mortgages could be subordinated to new acquisition or rehabilitation financing, to facilitate the provision of funds for this new debt. The underlying HUD debt could also be recast, modified, deferred, or written down in whole or in part, representing a one-time cost which would be more than outweighed by the reduction in future rental subsidy obligations. Additionally, HUD could utilize the authority provided by Section 181(g) of the Housing and Community Development Act of 1987 to facilitate the negotiated sale of HUD-held mortgages to state or local government agencies, on terms which extend their low and moderate income use. Title II should be amended to specifically authorize these additional incentives.

Tax Incentives. Outside of Title II, certain revisions to the tax code would greatly facilitate the preservation of prepayment-eligible projects.

First, there is a significant need to reduce the tax liability incurred by sellers who transfer their properties for continued low and moderate income use, provided that this discount is reflected in a lower sales price (e.g. through the equity compensation formula described above). Additionally, the low income housing tax credit program should be revised to allow a waiver of the current 10-year "anti-churning" rule if the transfer is necessary to preserve the project's existing income use. Extension of the credit in some form to units occupied by lower income households (with incomes below 80% of the area median) in existing subsidized projects would significantly increase the amount of equity that can be generated for preservation efforts. Finally, a specific allocation of tax credits for Title II projects would greatly facilitate the use of this tool for preservation initiatives.

Preferential Allocation of Incentives

Currently Title II provides no guidance or priority system for the allocation of preservation incentives. New legislation should require appropriate targeting of available resources and other benefits to advantage preservation efforts that provide the greatest degree of affordability, the longest period of low and moderate income use, and the most substantial state and local financial contributions.

For example, available rental subsidy resources and flexible subsidy funds should be targeted on a preferential basis reflecting these criteria. Special incentives, such as deferred capital improvements loans, reduced debt coverage on insured equity loans, and modifications of existing HUD-held mortgages should be provided only to projects sponsored by tenant, non-profit, public agency, or other purchasers committed to extending the project's existing use beyond the subsidized mortgage term. On the tax side, total forgiveness of capital gains tax liability should be provided only if the property is being transferred to a non-profit purchaser; and expanded low income housing tax credits should be limited to such purchasers as well. This type of preferential treatment would significantly enhance the potential for transfering Title II projects to alternative ownership.

Notice, Review & Comment, Pre-emptive Purchase Rights

Notice. Title II currently requires that the Notice of Intent (to prepay or seek incentives) must be filed with "any appropriate" state or local government agency, an ambiguity not further clarified by HUD's implementing regulations. Further, the Plan of Action may be submitted to "any appropriate" state or local government agency, presumably at the owner's option. Proposed HUD regulations would require owners to send a summary of the Plan to project residents, after it has received preliminary HUD approval.

In order to promote the active involvement all parties with an interest in project preservation, owners should be required to communicate their intentions and proposed plans to designated state and local housing officials in a timely manner. Additionally, consistent with the goal of tenant acquisition and with HUD's general statutory mandate to involve subsidized housing tenants in significant project decisions, project residents should receive the owner's Notice of Intent and should have access to the Plan of Action along with all supporting documentation prior to any formal action or preliminary funding commitments by HUD or state or local agencies.

Consultation. While Title II requires HUD to consult with and consider the views of appropriate state or local government agencies in approving proposed Plans of Action, HUD has not established procedures to implement this provision. Proposed HUD regulations would provide tenants with a 30-day period in which to comment on a summary of Plan after it has received preliminary HUD approval. Future legislation should provide formal and meaningful review and comment rights for designated housing officials of both levels of government as well as for project residents, to be exercised prior to the stage of preliminary HUD approval.

Pre-emptive Purchase Rights. The concept of pre-emptive purchase rights for qualified tenant organizations, non-profit sponsors, and state and local government agencies seeking to acquire subsidized projects has been established by legislation restricting the prepayment of FmHA mortgages, and, to a lesser extent, by statutes governing the disposition of HUD-owned projects. This approach should be extended to Title II, by providing such entities with an option or right of first refusal to purchase any prepayment-eligible project where the owner is seeking to terminate affordability restrictions or to sell subject to a Plan of Action including incentives.

The pre-emptive purchase right should be triggered when the existing owner files a Notice of Intent and should be subject to reasonable time frames, e.g. for submission of a purchase offer and execution of a purchase contract. The existing owner should be required to provide necessary documentation relative to the project's financial, physical, and occupancy status in a timely manner, to enable prospective non-profit purchasers to assess the feasibility of acquisition and to prepare a Plan of Action. The purchasing entity would be eligible for incentives on a priority basis subject to the criteria described above. In conjunction with the proposed targeted subsidy plan, this provision would significantly facilitate the preservation of projects through alternative ownership where qualified non-profit purchasers exist.

Alternative State Strategy

Title II's alternative state strategy provisions, which offer states the potential for a larger role in project preservation efforts in exchange for significant resource contributions, should be modified in several critical respects.

First, the current statute establishes different unit preservation standards for Plans of Action approved on the basis of an alternative state strategy, presumably in the interest of flexibility. Under the state strategy scheme, only 60% of the units in any given project—and 80% of the units statewide—must remain affordable to program-eligible tenants, including a mandatory set-aside of 20% very low income units; whereas other projects seeking incentives are required to preserve **all** pre-existing very low, lower income, and moderate income units "to the extent practicable." This dual standard creates the potential for a reduction of affordability in state strategy projects, and should be eliminated in favor of a uniform set of preservation requirements for all projects seeking incentives (see above).

At the same time, the statute as currently interpreted by HUD appears to make the state strategy provisions applicable only to Plans of Action involving the termination of affordability restrictions. This creates an incentive for owners to prepay their subsidized mortgages in order to take advantage of the additional resources committed under approved state strategy schemes, a result clearly not intended by Congress. The legislation should be revised to clarify that the state strategy option can be utilized for both prepayment and preservation projects.

Finally, in exchange for their resource commitments, states participating in alternative strategy schemes should be entitled to receive blanket set-asides of federal subsidy resources (e.g. Section 8, Flexible Subsidy) for allocation in accordance with the priority system proposed for all Title II projects. This would provide a genuine incentive for state financial participation, as well as a meaningful role for states that choose to contribute significant resources to subsidized housing preservation efforts.

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

OF THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

BY

EUGENE J. BURGER

CHAIRMAN, LOW INCOME HOUSING PRESERVATION STUDY GROUP

JUNE 20, 1989

INTRODUCTION

Mr. Chairman, my name is Eugene Burger. I am a REALTOR® and a CERTIFIED PROPERTY MANAGER from Mill Valley, California. I am the Chairman of the NATIONAL ASSOCIATION OF REALTORS® Study Group on Low Income Housing Preservation. This study group was appointed by the NATIONAL ASSOCIATION OF REALTORS® to develop recommendations on how to address the low- and moderate-income housing preservation issue. On behalf of the members of the NATIONAL ASSOCIATION OF REALTORS®, I would like to thank you and the Members of the Subcommittee for your commitment to preserving low- and moderate-income housing and promoting affordable housing opportunities for our Nation's citizens, and for this opportunity to testify on the preservation issue. The NATIONAL ASSOCIATION OF REALTORS® has the largest membership of any trade association, with close to 800,000 members representing all facets of the real estate industry including residential and commercial real estate development,

mortgage banking, home building, property management, appraisals and syndication.

The NATIONAL ASSOCIATION OF REALTORS® is pleased that this Subcommittee has decided to address the preservation issue as it considers and prepares comprehensive new housing legislation. The preservation of existing low- and moderate-income housing is one of the most pressing problems facing the housing community, and legislation is necessary to address it.

The Threat to Existing Low Income Housing

The principal threats to the existing inventory of low- and moderate-income housing are: expirations of existing rental assistance contracts, termination of low- and moderate-income use restrictions following prepayments of HUD-assisted mortgages, defaults on HUD-insured properties, and the aging and deterioration of public housing units. HUD estimates that contracts covering more than 3.5 million low- and moderate-income housing units will expire between now and the year 2000. The total price of renewing these contracts over this period, according to HUD, is between $116 billion and $200 billion of new budget authority. The lower figure reflects the estimated cost of replacing contracts with five-year vouchers; the higher figure reflects the estimated cost of renewing these contracts in-kind. The National Low Income Housing Preservation Commission reports that, of the approximately 645,000 units in the inventory of privately-owned, subsidized low income stock receiving support pursuant to the Section 221(d)(3) and Section 236 programs, 43% (280,000 units and 2,570 properties) are likely to default and an

additional 38% (243,000 units and 2,030 properties) are likely to prepay during the next fifteen years. A total of 334,000 units will be eligible to prepay. In a recent study of the modernization needs of the public housing stock, Abt Associates estimates that the "backlog" needs to repair and modernize the existing 1.3 million units of public housing may exceed $20 billion.

As these statistics show, there is a real and present threat to the existing stock of housing and housing assistance currently available to persons of low-income. The NATIONAL ASSOCIATION OF REALTORS® is pleased to participate in this hearing to address the potential loss of low-income affordability in thousands of privately-owned but federally assisted apartments.

The REALTORS® Study Group

The focus of our Study Group and this testimony is on realistic incentives that could be offered to existing investors who are eligible to prepay their HUD-assisted mortgages to induce them to remain in the program and provide ongoing housing for the low- and moderate-income families who are in need. Even though the NATIONAL ASSOCIATION OF REALTORS® opposes changing the terms of an existing contract by disallowing an owner's right to prepay their multifamily housing loan, we nonetheless believe that options should be explored whereby the needs of the tenants can be met while maintaining the legitimate rights of the owners to dispose of their properties. Our policy calls upon HUD to provide the necessary incentives to owners of low-income

housing to preserve their affordable housing units.

This testimony describes a method by which HUD can evaluate whether to provide incentives to a given project and what level of incentives should be provided. We believe that the method provides a sound, reasoned, cost effective way to avoid the legal and social disturbance that would ensue from large scale prepayments of existing low-moderate housing mortgages and to maintain a productive relationship between the government and the real estate industry. We do not want our focus to in any way reflect a lack of concern over the non-prepayment dimensions of the critical preservation problems mentioned above; however, we thought it would be best to use this opportunity to relay our particular experience and expertise in developing a response to one part of the entire problem.

To determine what government actions might most effectively preserve the low- and moderate-income character of privately-owned housing while continuing to provide a fair return to the owner, the Study Group examined case studies of several actual projects and developed a scenario of the types of incentives that would encourage an owner to maintain the project as low-to-moderate income housing.

Statement of Principles

At the beginning of the Study Group's consideration of how to address the prepayment problem, the Study Group agreed to several principles that we recommend the Subcommittee follow as it develops recommendations on this

issue.

These principles are:

- The Federal Government should maintain its commitment to supporting tenants and properties currently receiving assistance by renewing expiring rental assistance contracts, in kind. Furthermore, Congress should provide adequate funding for the incentives authorized in the Emergency Low Income Housing Preservation Act of 1987 (the Preservation Act).

- Rental assistance should be project-based and provided for terms of at least fifteen years. Providing long-term project-based assistance is the most effective way to protect low- and moderate-income housing because it guarantees the income stream for the owner and lender, making it possible to operate the project and obtain financing. These long-term rental assistance contracts are a key incentive that HUD can use to encourage owners to stay in the program. Because owners are required to maintain income use restrictions for the remaining term of the mortgage, rental assistance contracts must coincide with the entire term that these restrictions apply. If subsidies are terminated, then Congress and HUD must allow the owners to prepay. It is a disincentive to the ownership of low- and moderate-income housing to impose long-term income restrictions while providing only short-term rental assistance.

- We believe the implementation of the Preservation Act must be project-specific to allow HUD the flexibility to provide the specific amount and

type of incentives appropriate in each case.

- HUD must consider the cost-effectiveness of each incentive package. Some projects will be too expensive to preserve, and Congress should allow prepayment with appropriate protections for subsidized tenants to mitigate any adverse effects of future rent increases. HUD should consider providing for individual release of units on HUD-insured mortgages to encourage the conversion of such projects to home ownership in which existing residents have an opportunity to acquire their units at a discount.

- Congress and HUD should develop and authorize additional incentives to increase HUD's ability to address this problem.

- Once an owner applies to HUD for prepayment, HUD should be required to authorize the prepayment or offer the owner incentives as an alternative to prepayment within 120 days of the owner's submission. HUD's failure to respond in a timely manner automatically authorizes the owner to prepay within a specified time period.

- The approach to preservation must be comprehensive and the Federal rules on prepayment should supersede and pre-empt any state laws on preservation. These are national housing programs, hence the rules need to be uniform in every state. Furthermore, once HUD decides on certain incentives or allows a project to prepay, the State must not have the authority to impose further requirements or restrictions on that project.

- By January 1, 1990, States should be encouraged to develop suggested preservation plans that complement the Federal requirements for properties within their jurisdictions and to make these plans known to HUD. Concurrently with the HUD application for prepayment, the State should be encouraged to analyze the projects and to determine the extent to which the property serves the public interest. If the preservation of a project as low- to moderate-income housing is cost effective and meets the State's needs for this type of housing, the State needs to supplement the financial incentives of the Federal Government. States should provide additional incentives, not punitive or expensive requirements.

- In syndicated projects, the general partner has a compelling fiduciary responsibility to limited partners.

- Principals have a right to rely on negotiated contractual agreements and the Federal Government, as a principal, has no right to abrogate an agreement.

BACKGROUND

In the seventies, in an effort to produce safe, decent housing for families of low and moderate means, numerous Section 236 and BMIR properties were developed in a relatively short period of time. As an inducement for owners to attract investor limited partners to provide the necessary capital and to participate in this extraordinary public program, special tax benefits

were granted by Congress. Contracts were entered into between these private limited partnerships and the Federal Government which became the guiding documents for the production and eventual operation of these properties. One of those contracts, known as Addendum "A" to the property deed, allowed, under certain circumstances, the original forty-year mortgage (under HUD programs) or the fifty-year mortgage (under FmHA programs) to be prepaid at the end of the first twenty years of operation. This fact as well as the tax benefits were understood by the investor limited partners at the time they committed the necessary capital to the projects. Since 1986, there has been a steady erosion of the financial benefits upon which the initial investment was made. As you know, the Tax Reform Act of 1986 dissolved the remaining tax benefits from the investment in the partnerships. The removal of the tax benefits left the partnerships with the one remaining inducement provided in the original investment programs: the ability to prepay the mortgage and realize the full economic value of the property in the conventional market.

However, responding to concern over the loss of low income housing units that would occur if many owners were to prepay, Congress passed the Emergency Low Income Housing Preservation Act of 1987 (the Preservation Act). The Preservation Act restricts the ability of owners to prepay their HUD-assisted mortgages and authorizes a set of financial incentives which HUD may use to encourage owners to forego prepayment and continue to operate under the low- and moderate-income use restrictions. The Preservation Act has effectively imposed a moratorium on all prepayments because the criteria for approval of prepayments is so stringent. Accordingly, many investor limited partners feel that they are being penalized by Congress for having invested in low- and

moderate-income housing during a period in which Congress provided incentives for them to do so.

The industry is well aware of the potential adverse impact of large scale prepayments of these existing mortgages on existing tenants. However, the industry is not the cause of this potential problem and feels very strongly that our contractual rights are being violated. By drastically altering the financial basis upon which investments in low- and moderate-income housing were made, Congress has effectively eliminated this type of housing from the capital markets and jeopardized future commitments by lenders, developers, and investors.

Under the current moratorium, certain incentives are put forth to encourage owners to continue to participate in the various housing programs. The problem is not the incentives, but rather the process that would enable interested owners to participate. To encourage continuation in the program, the processing of applications and the allocation of incentives needs to be timely, reasonable, and based on criteria that require only limited bureaucratic discretion.

Preservation Act Incentives

The incentives authorized by the Preservation Act offer several effective ways to provide sufficient financial return to owners to encourage them to agree to extend their regulatory agreements with HUD. The incentives in the Preservation Act include increases in the income stream and the recapture of

equity from a project. Some of these incentives, such as increasing rental assistance payments, require additional government expenditures and some, such as the Section 241(f) second mortgage insurance program, do not.

HUD must vigorously implement these incentives and Congress must adequately fund them to effectively address the preservation issue. Currently, this is not occurring. We understand that many "plans of action" required by the Preservation Act have been filed, but HUD has not responded to them or attempted to engage in negotiations with the owners to extend the use restrictions and provide additional financial return to the owners.

For instance, it is very difficult to use the Section 241(f) mortgage insurance program because the application process is unwieldy. A primary reason for this is that applications are processed by the HUD production staff instead of the loan management staff. When dealing with the production department, there are numerous time-consuming procedures, involving various architectural reviews and bids, all of which cost money and time. A much more practical approach would seem to be the management plan application process, which HUD currently uses for other programs. The process still requires competitive bidding but reduces the architectural reviews. Also, while Section 241(f) mortgage funds would continue to be used to cure deferred maintenance and make capital improvements, the major focus would be on returning equity to the investors for staying with the original program. We believe that the owners can recover the current incremental value by increasing current rent levels that have been suppressed because of current HUD rules and regulations. Allowing the rents to increase, perhaps over two

or three years, will provide additional value that can then be returned to the investor limited partners annually as is now done, or used as the basis for a secondary 241(f) loan allowing the investor limited partners to withdraw their equity.

Proposed changes to 1987 Act Incentives

Changes should be made to the existing incentives and additional incentives should be provided to establish as many tools as possible to preserve as much of the economically sound low- and moderate-income housing inventory as possible. Incentives will affect the particular needs of each project differently; therefore, flexibility in providing inducements to owners is necessary. We recommend the following changes be made to the existing Preservation Act incentives:

- Allow project-specific FMR waivers for some projects. (Allow HUD to raise the rents permitted under Section 8 notwithstanding FMR limits.) This change would allow HUD to review an individual project's specific circumstances and determine whether a FMR waiver would provide sufficient rental income to raise the return to an owner to an acceptable level.

- Remove or reduce the downpayment requirement under the Capital Improvement Loan Program. The current downpayment requirement of 20-30% is unreasonably burdensome.

Additional Incentives

- Allow recasting of existing mortgages.

- Allow increases in management and special fees to compensate for the additional work effort required in the preservation process.

- Provide for a step-up in depreciation basis for existing programs in developments which (1) are sold and which are locked-in by the acquiring entity for affordable housing for a period of more than ten years or (2) are retained but are locked-in for affordable housing for a period of more than ten years.

- Waive capital gains taxes for sale to new owner who will preserve use restrictions.

- Allow owners of Section 236 projects with tenants paying rents in excess of government-allowed rent levels to retain the excess rent receipts in their projects instead of passing these excess rents through to HUD.

- Waive existing tax-exempt bond limitations for revenue used for preservation activities.

- Allow the losses from low- and moderate-income developments to be treated as "non-passive."

- Provide subsidy contracts for the entire term of the extended lock-in period.

- Allow second mortgages to fund improvements or to provide funds for distribution to owners.

PROPOSAL FOR RESPONDING TO PREPAYMENT APPLICATIONS

Because of the difficulties arising in HUD's attempts to implement the Preservation Act, the NATIONAL ASSOCIATION OF REALTORS® believes that Congress must modify the Preservation Act to provide additional guidance to HUD regarding how to respond to prepayment applications. Specifically, we believe that Congress must tell HUD which projects qualify for incentives to encourage the extension of low- and moderate-income use restrictions.

We recommend a set of criteria that will allow HUD to respond to plans of action in a way that protects the government's interest while providing a fair return to project owners. Owners will want to prepay in those circumstances where the fair market value based on their property's highest and best use exceeds the value of the project based on its current use under government restrictions. However, as a general statement, many investors would opt to remain in the program if HUD were to provide incentives that would enable them to realize a return on their investment that is equivalent to what they can obtain if they were to prepay.

Thus, we anticipate that an owner will be willing to maintain his or her

project under low- and moderate-income use restrictions if the government provides or allows financial incentives which will approximate a reasonable return based on the project's fair market value based on highest and best use. Of course, the fair market value based on highest and best use must take into account all necessary and reasonable costs of converting from a current use to a new use. We agree with the suggestion made in several of the papers submitted to the Subcommittee that indicate that an appraisal process can arrive at this value.

Another way of looking at the value of a project is to consider what the project's value would be assuming that all the units in the project are rented at the HUD-established fair market rents (FMRs) for the area. This is a good estimate of the project's fair market value as a rental property <u>without government rent restrictions</u>. In fact, we believe that, in most circumstances, projects will have their highest and best use when all units are rented at the fair market rent level.

If the fair market value of a project based on highest and best use is less than or equal to the fair market value of a project under current rent restrictions, then HUD should reject a prepayment application without providing additional incentives. In this situation, the owner has no incentive to prepay and HUD does not need to provide incentives to preserve this housing for low- and moderate-income use.

If the fair market value of a project based on highest and best use is greater than the fair market value of a project under current restrictions,

then HUD should approve a package of incentives approximately equal to the difference between the fair market value based on highest and best use and the fair market value under current restrictions. Under this approach, once a property's fair market value based on highest and best use is determined, HUD can then review that project's situation and develop a package of flexible rental restrictions, subsidies, and financial incentives which will result in a reasonable return based on that value. For example, if a property's fair market value based on highest and best use is determined to be $2,900,000 and the fair market value based on current use under government restrictions is only $1,800,000, then an owner will be looking for an incentive package to create an additional return based on an increased value of $1,100,000. (There is an explanation of these calculations at Appendix A.)

However, if the fair market value of a project based on highest and best use is more than 20% greater than the fair market value of a project as an uncontrolled rental property, then HUD should consider allowing the project to prepay because it may not be cost-effective to provide the additional incentives necessary to provide a reasonable return to the owner. The level at which HUD actually determines that providing incentives is not cost-effective for a particular high-value project may be different than this level, depending on the particular circumstances of the project in question. However, HUD should have the authority to allow projects to prepay, and this authority should not be constrained as tightly as it is under the stringent criteria established in the Preservation Act of 1987.

Using this method, HUD can negotiate with owners and tailor a specific

set of incentives that meets the needs of the owners and the tenants while recognizing the limited financial resources of the government. We think it is reasonable to expect the Federal Government to provide adequate incentives for those investor limited partners interested in staying in the program as long as those incentives would, in the long run, be less expensive than the cost of prepayment and the replacement of existing housing.

CONCLUSION

In closing, Mr. Chairman, allow me to thank you again for the opportunity to discuss the NATIONAL ASSOCIATION OF REALTORS®' perspective on the issue of preserving low income housing. I sincerely hope that the National Affordable Housing Act will include provisions aimed at preserving low income housing and providing additional incentives and guidance on how those incentives should be used on properties that are eligible to prepay. We look forward to working with you and the Subcommittee to develop such provisions and working to pass and enact them into law. Thank you very much for the opportunity to testify before the Subcommittee.

APPENDIX A

SAMPLE PROJECT

Number of units = 100

Current "Controlled" rent per unit ($375 x 12)	=	$4,500
Current operating cost per unit	=	$2,700
Current "Market" rent per unit ($700 x 12)	=	$8,400
Current operating cost per unit	=	$3,500

Assuming a capitalization rate of 10% for each use, the values are as follows:

Current "Controlled" Value

Rent per unit -- annual	=	$4,500
Operating costs per unit -- annual	=	2,700
Net operating income per unit -- annual	=	1,800

$1,800 net operating income per unit x 100 units = $180,000
Annual net operating income capitalized at 10% equals current market investment value of $1,800,000.

Current "Uncontrolled Market" Value

Rent per unit -- annual	=	$8,400
Operating costs per unit -- annual	=	3,500
Net operating income per unit -- annual	=	4,900

$4,900 net operating income per unit x 100 units = $490,000
Annual net operating income capitalized at 10% equals current market investment value of $4,900,000.

Assuming that the cost for capital improvements to bring the property to comparability with the existing market units is $2,000,000, the fair market value at highest and best use is then $2,900,000.

Comparing the fair market value at highest and best use of $2,900,000 with the market value under current restrictions of $1,800,000, we find the owner might accept incentives/subsidies based on the increased value of approximately $11,000 per unit or $1,100,000 to forego prepayment and to continue to operate under existing conditions. The additional incentives should increase the net operating income of the property by $110,000 annually.

National
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Hon. Edward W. Brooke, *Honorary Chairperson*

Barry Zigas, *President*

6/15/89
Memorandum
Re Preservation of HUD Housing

Prepared by Ad Hoc Preservation Committee:
Sylvia Martinez, Vice Chair, NLIHC; Member, California Senate Working Group on Preservation & Board of Directors, Northern California Association for Non-Profit Housing -
Michael Kane, NLIHC Board; Executive Director, Boston Affordable Housing Coalition
Ann Rich, Executive Director, Lakeview Tenants Organization, Chicago
Larry Yates, Director, National Anti-Displacement Project, LIHIS

Background

This paper makes legislative policy recommendations on preservation of at-risk HUD-assisted housing. It was prepared with the input of advisory meetings in Chicago, Boston and Berkeley during May 1989. In each case, these meetings built on at least two years of ongoing discussion of these issues in that city -- in Chicago, by the Coalition to Preserve Subsidized Housing; in Boston, by advocates working on legislation in that state; and in the Bay area, by the Northern California Association for Non-Profit Housing. The points in the paper were the general consensus of those present, as summarized and refined by the Ad Hoc Committee by mail and conference call. The organizations represented at the three meetings are listed at the end of the paper for the purposes of identification; not all of them endorse all positions in this paper. The paper was circulated to the NLIHC Executive Committee in June 1989.

Summary

This paper puts forward specific proposals, growing out the past positions of the NLIHC as expanded on by an intensive national grassroots process, for action on this issue by Congress in 1989. The goals driving these proposals are unchanged:

1) To preserve the substantial existing stock of privately owned subsidized housing for low income people;
2) To ensure the participation of residents in the fate of this housing stock;
3) to promote transfer of this housing stock to nonprofit and resident control and thus to permanent affordability; and
4) to respond to this problem with the most cost effective possible use of scarce federal housing resources.

The means by which these goals can be carried out are presented below within the framework of the existing law, the Emergency Low Income Housing Preservation Act of 1987. This Act has proven itself as a source of real and appreciated protection, albeit temporary, to endangered tenants. It is also familiar to Congressional housing leaders, and has withstood initial court tests. However, the 1987 Act clearly needs modifications and improvements beyond merely continuing it past its 1990 expiration. The changes recommended here can be summarized as:

a) extending the restrictions on prepayment permanently, with provisions to ensure that owners receive the constitutional requirement of a fair value for their property;
b) strengthening notice and participation provisions, especially for residents of at-risk housing;
c) strengthening, adding to and improving the incentives provided in the 1987 Act for actions to preserve this housing;
d) establishing a method of prioritizing these incentives; and
e) correcting "loopholes" in the 1987 Act.

In addition, this paper proposes tax-related legislation to preserve HUD-assisted housing, and also proposes a response to the crisis of expiring Section 8 rental subsidy contracts.

Prepaying properties

(Organized roughly along the lines of the '87 Emergency Low Income Housing Preservation Act)

Duration of 87 Act Process -- The Act should be extended permanently, with a clear formula for owner compensation to ensure constitutionality. By this formula, fair return to owner(s) in case of a sale should be considered to be: Owner's cash investment plus any documented additional cash in project plus yield based on Consumer Price Index plus any recapture and/or capital gains tax liability less any cash distribution. (This formula would include all compensation, to general and limited partners, to be divided among them according to partnership agreements.) This formula was crafted by Emily Achtenberg and others in Boston to meet a constitutional test, while minimizing the owner windfall and thus the cost of transfer to resident, nonprofit or public ownership.

Notice of Intent to Prepay

It is not too strong a statement to say that confusion reigns in this area. Though Congress clearly intended that owners would make a public notice of their intentions, facilitating community involvement in the prepayment process, this has generally not occurred. Only a few months have passed since, through a LIHIS Freedom of Information Act request, the list of the owners who have filed notices of intent to prepay became publicly available for the first time. Clearly, the vast majority of affected tenants, as well of government officials, community leaders, concerned citizens and media staff in affected communities have no idea of the impending threat. In addition, the actual intent of owners who do file notice is far from clear in many cases, and can only be determined by a full discussion with them at the local level.

To remedy this situation, these changes are necessary:

-- notices of intent to prepay should be filed w/ both state and city chief elected official or designee;

-- 24 months notice should be given to tenants, to include rights and remedies, and all information available about their situation. There should be well-publicized opportunities for resident input into any Plan of Action, Transfer of Physical Assets, or other process likely to significantly

affect them. There should also be HUD tenant ombudsmen, a HUD "hotline", and manuals for residents.
-- in order to enable residents and nonprofits to successfully plan preservation actions, mandatory access to project financial data should be provided to potential resident and nonprofit buyers.

Incentives -- The sections on incentives should be rewritten, partly to clarify that giving owners incentives to stay in and facilitating acquisitions into social housing sector are two different activities. The most common and legitimate complaint of owners of at-risk housing is that Congress and HUD have failed to provide adequate and effective incentives. As nonprofit acquisitions increase, the same failure will almost certainly cripple these efforts. The currently available incentives should continue and be made more accessible and effective, and additional items should be included in the list of ncentives. HUD should be clearly required to fully use all available incentives.

The following additional incentives should be provided:

-- the grant process from the Edwards-Pelosi bill (H.R. 1057), at an amount of $800 million. This bill, strongly influenced by Northern California advocates and nonprofit developers, was the subject of a community hearing in San Francisco that also publicized the Two Cents for Housing campaign. In its present form, it proposes $439 million for grants for nonprofit acquisition, channeled through state governments, and allocated according to the number of units at risk in each state. Projects preserved under the proposed method would be permanently affordable.

-- Adequate project-based Section 8 funds, or an equivalent rental subsidy stream, must be available, especially for very low income tenants. Provision of such subsidy by HUD for these tenants should be mandatory, not optional.

-- Recast original 221(d)(3) and 236 mortgages at the original rate to include new debt for nonprofit purchases and rehabilitation, with interest write-downs from HUD, or a financial equivalent, would be useful tools.

-- HUD mortgage insurance should be available on a 100% loan to value basis on sale of a for-profit owned property to a nonprofit.

-- Technical assistance and pre-development assistance should be available to resident organizations and to nonprofit groups. If HUD develops the capacity proposed elsewhere to assist tenants, this should flow through HUD, with initial funding at $10 million. Residents and nonprofits should have the ability to hire independent staff as necessary, including tenant organizers, development specialists, architects, etc.

-- $500 million in flexible subsidy operating assistance should be available to meet the needs of at-risk properties. This should be used primarily for financially distressed properties. This figure is based on estimates of likely defaults and financial problems developed by the National Low Income Housing Preservation Commission.

--Early prepayment and Plan of Action approval before the 20 year point should be allowed in cases of sale to a nonprofit or public agency or to residents. Waiting until the property is eligible to prepay can mean waiting until its price reaches its height.

--Joint plans of action by both parties on sale by a for-profit to a non-profit should be encouraged and specifically provided for.

Other forms of subsidy than Section 8, such as the grant process in the Edwards-Pelosi bill, are preferable for the sake of cost-efficiency when available and practical.

Priorities

Here, we propose a new section of the Act. In addition to providing weak incentives, the 1987 Act gave no guidance as to how inevitably scarce incentive resources should be used. Setting priorities not only makes administrative and community decisions easier, it provides a method of promoting those types of deals

which are socially and budgetarily desirable. These priorities should be applied to the incentives and subsidies offered in the 1987 Act and to those that are added.

These priorities are listed independently. To implement them, HUD would set up a rating and ranking system based on these priorities for Plans of Action, and make subsidies available based on such a system.

-- Higher priority should be given to a Plan of Action involving transfer to a not for profit entity, especially a resident coop or nonprofit community development corporation, but also including local and state governments. A lower but still real priority should be given to sale to a competitive purchaser where there is resident involvement in choice of purchaser and where there are resident management arrangements.

--Higher priority should be given to Plans of Action involving acquisitions with a lower development cost (sales + rehab) in proportion to outstanding mortgage, taking into account local market conditions.

--Higher priority should be given to Plans of Action involving bargain sales by a for-profit owner to a nonprofit .

-- Higher priority should be given to Plans of Action with a higher state and local government contribution, unless the applicant has demonstrated that there is no further available and applicable funding from state and local government.

Higher priority should be given to Plans of Action that serve a higher proportion of very low income persons, and/or improve affordability within the project for very low income persons.

Plans of Action

The Plan of Action process is central to the process proposed by 1987 Act. At this time, there is very little experience with the process; HUD has approved only one Plan of Action, and has apparently not acted finally on any others. However, there are certain "loopholes" visible in the existing law that should be

corrected in these ways:

-- Drop the language in the 1987 Act in Section 225 (b)(3)(F)(i), "to the extent practicable", which gives HUD an "out" from providing subsidies to tenants following the original tenants. Provision of such subsidies by HUD should be mandatory, not optional;

-- No resident in place at the time of the Plan of Action should pay more than 30% of income for rent;

-- In order to ensure predictability of income for nonprofit and resident ownership situations, the existing tenant income profile in place on January 1, 1987, should be maintained, with no tenant paying more than 30% of income in any category.

-- The impact of rent increases at the time of the plan of action and in the future on residents should be detailed, and displacement of residents should be prohibited;

-- Restrictions to ensure low-income affordability of the project should be extended for "the useful life of the project" if any incentives are accepted. However, this should not be allowed to encourage undermaintenance that might lead to a shorter useful life.

--In order to approve a Plan of Action, HUD must make a finding that the Plan does not decrease housing opportunities in the area. HUD should be given a more stringent standard for finding this, such as showing that there are no waiting lists in the area for subsidized housing, and that there are no homeless families in the area.

Right of first refusal or of pre-emptive option for residents, nonprofits, local or state government should be required. With this provision, any sale will provide an opportunity to transfer the property to the nonprofit sector and to permanent affordability. However, such provisions must be written tightly enough that the title to ultimate owner is not clouded by uncertainty as to whether this right has been been properly given. State laws offering this right in Rhode Island and Maryland should be studied.

Rent Increases -- Tenants in at-risk housing are facing the threats of prepayment and of expiring Section 8 contracts. At the same time, many of them are facing almost annual rent increases. These rent increases, often approved by HUD without sufficient examination, have the potential to displace tenants on their own. We propose that all rent increases in 221(d)(3) and 236 projects should be justified not only on the basis of owner cost but of avoiding displacement of current tenants. Audited justification of rent increases should be available to tenants.

Alternative State Strategy -- The concept of an alternative state strategy has sparked no interest outside of Massachusetts. The Boston meeting recommended that either this alternative be removed as an option, or criteria for alternative state strategies be as stringent or more stringent that those throughout the Act. (The Massachusetts proposal is more stringent than the Act.)

Tax treatment of sales -- Capital gains exclusions should be available to for-profit owners who sell to nonprofits. This exclusion should be reflected in the price to the nonprofit. If necessary, a balanced appraisal process should be used to ascertain that this has been done. Permanent low income use restrictions should be applied following such sales. No tax benefits should be given where there is only a syndication or other for-profit restructuring. (Tax legislation, of course, will not be part of a modified 1987 Act, but will be acted on in the tax committees of Congress.)

Expiring Subsidies

Because the Section 8 program ensures owners a fair market rent, owners should be restricted from terminating or opting out of Sec. 8 contracts. Lock-ins should be extended for "useful life of the project". Increases in rent up to or even beyond 120% of fair market rent should be considered by HUD. Section 8 contracts should be renewed on a "like term, like kind" basis -- that is, a 15 year contract for

project-based Section 8 should be replaced with a 15 year project-based contract, not a 5 year voucher contract. This spring, NLIHC has successfully advocated with the Budget and Appropriations committees to provide adequate funding for such contract terminations; this work must continue.

TPA Loophole -- owners can sell properties (referred to by HUD as a TPA or Transfer of Physical Assets) rather than prepaying. This does not remove the HUD restrictions, but has resulted in massive rent increases, especially for lower income tenants not receiving Section 8. The same protections listed above should be extended clearly to TPAs as to prepayments re: notice to tenants, affordable rent, prioritization of subsidies, etc.

Rent Standards

While 30% of income has become, by practice during the 1980s, a recognized standard, it offers real hardship to many very low income tenants, especially in larger units and in higher cost areas. Congress should look at other approaches to setting rent, such as returning to the early Section 8 standards of 25% of income for rent and less for very low income, or a market basket approach to resident affordability.

Tax Credits

A separate pool of tax credits should be available for transfer of at-risk properties to nonprofits. This pool should be in an amount beyond the regular allocation, and should reflect the following special conditions: 1) no 10 year "churning" rule; 2) permanent low income restrictions on the property; 3) the credits should be offered 5 years prior to the date of prepayment.

INFORMATIONAL LISTING OF GROUPS INVOLVED IN THE PROCESS

Organizations represented included:

Chicago
Lakeview Tenants Organization
Statewide Housing Action Coalition
Lawyers Committee for Better Housing
Chicago Rehab Network
Leadership Council for Metropolitan Open Communities
Chicago Coalition for the Homeless
ACORN
Uptown Tenants Union

Boston
Boston HUD Tenant Alliance/Boston Affordable Housing Coalition
Tent City Corp.
City of Boston
Mass. Law Reform Inst.
Emily Achtenberg, consultant
Community Economic Development Assistance Corp.(state of Mass. Agency)
Western Mass. Community Loan Fund
Mass Tenants Organization
Boston Redevelopment Authority
Boston Housing Partnership
Greater Boston Legal Services
The offices of U.S. Rep. Kennedy and state Rep. Fitzgerald

Berkeley

The meeting was co-sponsored by the NLIHC and the Northern California Association for Non-Profit Housing, and held at the offices of the National Housing Law Project. Other organizations represented there included:
Institute for Community Economics
Center for Community Change
the San Francisco Coalition for Low-Income Housing
Mid-Peninsula Housing Development Corporation
the California Coalition for Rural Housing Project,
Santa Clara County
City of Sacramento
Marin County
City of Oakland.

June 20, 1989

TESTIMONY OF
CONRAD E. EGAN, EXECUTIVE VICE PRESIDENT
NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS
ON MULTIFAMILY PRESERVATION ISSUES
TO
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

Thank you, Mr. Chairman, for the opportunity to present to this Subcommittee some observations and suggestions on the continued affordability of this nation's federally subsidized multifamily properties. The National Corporation for Housing Partnerships (NCHP) was authorized by Congress in 1968 to stimulate the production of low and moderate income housing. NCHP is now the largest owner of low and moderate housing in the United States -- more than 60,000 such units in 40 states. Our portfolio includes approximately 250 properties that are of the older subsidized variety which are the primary subject of this roundtable hearing.

The time for further study and debate on this question is past. Action is required now if this irreplaceable affordable housing resource is to be preserved. My comments today, therefore, are brief and to the point.

The following actions are required immediately:

- The incentives provided in the Housing and Community Development Act of 1987 to encourage the preservation of properties should be implemented without further delay, particularly the federal funding that is necessary to make these incentives work. Special emphasis should be placed on implementing one of the most effective incentives -- equity take-out loans. Key among the funding sources for these actions must be a reconstituted revenue calculation at the level of each property, with adjusted rents and additional subsidy as required. What is in essence a reunderwriting of these properties should commence immediately, as I have proposed below, for all older subsidized properties.

- In addition to the incentives already provided, those owners choosing to sell their properties to qualified entities who will retain the affordable restrictions should have their tax upon sale adjusted

in proportion to the continued affordable restrictions. Such an option will encourage preservation and recapitalization at minimum cost to the government.

Although prepayments have become the most prominent facet of the issues and opportunities facing this nation's federally subsidized multifamily properties, I would suggest, as has also been determined by the Low Income Housing Preservation Commission, that such additional issues as expiring subsidy contracts and the need to recapitalize these properties are at least equally serious threats to continued affordability. I therefore recommend:

- That a proactive process be established, under the direction of the Department of Housing and Urban Development, with involvement by the States, to develop specific preservation strategies for each property and to enter into an agreement with the owners to implement those strategies;

- That this process include specific timetables and priorities, starting with the worst properties and those most likely to prepay; and

- That key among the components of each of these strategies is a resolution of the future subsidy and physical needs of these properties.

The nation's federally subsidized properties are too important a resource and the risk of loss through prepayment or default too great to leave the resolution of these issues to a reactive relegation of responsibility solely to the owners. What is needed now, and what many other witnesses have also suggested, is a reunderwriting of these properties -- in essence a recalculation of their needs and resources -- as they are recapitalized and repositioned as continuing affordable housing resources. If HUD, armed with the above-listed incentives, were to adopt a more vigorous posture of "let's make a deal -- now", issues which will have to be dealt with sooner or later anyway could be dealt with now at minimum cost to the taxpayer and maximum benefit to the residents, the owners, and the government.

TESTIMONY BY BRENDA TORPY,

DEVELOPMENT COORDINATOR,

NORTHGATE NON-PROFIT

for

SENATE SUBCOMMITTEE ON

HOUSING AND URBAN AFFAIRS,

ROUNDTABLE HEARING ON

THE PRESERVATION OF SUBSIDIZED HOUSING

JUNE 20, 1989

Brenda Torpy
Development Coordinator
Northgate Non-Profit
c/o BEAM
135 Church Street
Burlington, Vermont 05401

I. INTRODUCTION

Northgate Non-Profit is a non-profit developer dedicated to tenant control and ultimate ownership of a 20-year old 221(d)(3) project. This paper describes our preservation experience and our recommendations for future legislation at the federal level.

Title II of the Housing and Community Act of 1987 has provided an interim solution to the loss of subsidized housing, and one which local governments and tenant groups have been able to utilize to prevent massive displacement in communities like ours.

Our experience in Burlington, Vermont, as described herein, supports the need for permanent legislation in support of low income housing preservation. Such legislation must provide adequate development, rehabilitation and rent subsidy resources to meet this critical need. It must also encourage non-profit and public ownership of such housing because these will retain the public subsidy for the benefit of low income tenants into the future projects. Non-profit or tenant ownership is thus the most cost effective, permanent solution to the crisis we now face.

II. NORTHGATE NON-PROFIT: HISTORY AND PURPOSE

Northgate Non-Profit (NNP) was incorporated in May of 1988 to acquire, rehabilitate, and preserve the affordability of Northgate and Greenfield Apartments. This project houses 336 families; and with 76% of these below median income (53% are very low income), Northgate constitutes 25% of Burlington's affordable rental housing. Our effort actually began a year earlier with the SAVE NORTHGATE TASK FORCE, created and funded by a City

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Council Resolution that brought together the private and public interests concerned with the preservation of this community resource. Our non-profit board includes tenants, city and state government representatives, local churches, low-income advocates and non-profit developers. Out of a total development budget of $21,000,000 we have raised $18 million and plan to close by the end of the calendar year.

City government also financially supported the tenant association as well as the non-profit in those critical early years. Without this pre-development assistance, the project would not have gotten off the ground. Strict anti-condo conversion legislation passed in 1987, and mayoral leadership in our negotiations, sent a clear message to the sellers that Burlington was a community that valued its affordable housing. The municipally owned Electric Utility will also contribute funds to the conversion of Northgate from electric to gas heat, and to the weatherization measures that constitute the bulk of our rehabilitation. A local fund-raising drive, spearheaded by the churches, also raised community awareness and precious pre-development funding.

A critical application of these "softer" funds has been for the support of tenant participation. Today, tenants have 3 of the 11 seats on the NNP Board. At the end of the development, the tenant association will have 8 of 11 seats on the managing general partner of the new ownership entity. Northgate tenants are currently in the process of developing new house rules and policies in conjunction with the development staff. They have also developed criteria for the selection of a new management

agent and begin interviewing these in July. Tenant management and ultimate tenant ownership are major goals of NNP, but meaningful tenant participation and empowerment requires funding for organizing staff, training and education, community building activities, and support services. Without such support, Northgate tenants could not have kept up with the development process, let alone affect it.

A number of other factors unique to our project should be highlighted here, as they support the goals of the Preservation Act and provide an example of what can be done at the state as well as the local level to enhance federal legislation and funding for preservation.

In 1986, Vermont's State Housing Policy established preservation as the top housing priority. In addition to targeting existing funds to this priority, two new resources were created: the Housing and Conservation Trust Fund and the Vermont Equity Fund. The first, funded by State revenues, provides grants and deferred payment loans to preserve and create perpetually (non-profit and cooperative) affordable housing. This fund has committed $3.1 million to Northgate Non-Profit for pre-development costs and rehabilitation. The Equity Fund is a pool of tax credit investment available only to non-profits and administered by Housing Vermont, a development arm of the Vermont Housing Finance Agency (VHFA). Both entities were created and capitalized by VHFA to support non-profit development and preservation of affordable housing. Northgate Non-Profit and Housing Vermont will create the Limited Partnership that will own and manage Northgate, bringing almost $5 million dollars of

equity to the project for acquisition and rehabilitation.

Given these incentives for - and commitment to - non-profit development, the owners of Northgate approached the VHFA and offered to negotiate a sale that would meet the State's preservation goals. The following structure resulted to address their needs as well as ours: below-market rate seller financing in conjunction with an installment sale through an interim purchase by the VHFA, who will issue tax exempt bonds. Thus, we received the project at a price substantially below market, and the sellers reduced their tax liability. Moreover, the 221(d)(3) mortgages are still in place, providing $3 million dollars of 3% financing to the project.

III. FEDERAL INCENTIVES FOR NON-PROFIT PARTICIPATION IN PRESERVATION

In spite of the strong State and local support for Northgate, we need federal assistance to make our project work - specifically, HUD approval of our transfer and the waivers required to blend all of these sources, project-based rent subsidies, and rehabilitation assistance. We have been working with HUD Preservation and field staff, and based upon our experience to date would like to make the following suggestions in support of their preservation mandate under Title II:

1. An **Office of Preservation** should be created at HUD that has adequate funds and authority to carry out its purpose. Currently it is hard to coordinate all the branches that have a role in our project and make the various programs work together. Special set-asides of subsidy and grant funds should be allocated to this

office to avoid competition with other housing needs (such as Flex funding for troubled projects).

2. **Project-based rental subsidies** are essential to prevent the displacement of the families most in need of this housing. Although our rents are lower than the local market and HUD FMR's, more than half of our families could not meet them without Section 8 assistance. Vouchers are not adequate if long term affordability and project viability are to be achieved.
3. Non-Profits also need **up-front grants** to develop feasible projects. We were many months in preparation just to get to the negotiating table. Perhaps such federal grants could be established to match local and state commitments of pre-development funding, to maximize the benefit of the funds, and to encourage local responsibility. Tenant participation should also be a criteria for such funds.
4. **Capital grants for repairs and improvements** should also be available to non-profits for rehabilitation and energy conservation. This is also critical to the long-term viability and affordability of this housing. We cannot afford to finance substantial improvements today, and we cannot risk needing to do so in, say, five or ten years. The Flexible Subsidy Rehabilitation Program that allows deferred payment loans meets this need, but it is woefully under-funded.
5. Finally, the Preservation Act should favor **non-profit acquisitions** of at-risk housing because it will save

money in the long run. Incentives that keep private owners in only defer and augment the problem. Incentives should be provided that encourage owners to sell to tenant associations and local non-profit corporations. One incentive would be to forgive capital gains on sales to non-profit owners or tenant coops. HUD should also have special incentives for non-profits (such as the pre-development and rehab grants described above).

Many of these suggestions are echoed in the advance papers prepared for the Subcommittee. Mr. Grow of the National Housing Law Project best expresses the advantages of non-profit buyouts as well as the need to support such through a comprehensive package of pre-development funding, ongoing rent subsidies, and rehab assistance. Emily Achtenberg also recommends facilitating non-profit and tenant ownership and goes on to outline practical steps to do so. Both of these authors also address the issue of balancing compensation to the current owners with the public purpose of the Preservation Act. Achtenberg's suggested formula on page 4 meets both tests. This, or a similar approach, should be specified in the Preservation Act.

Mr. Siflinger of NCSHA also supports the transfer of projects to non-profit ownership through tax incentives and preferential funding. I also wish to highlight his recognition that states do not have adequate resources to replace federal assistance. Even in pro-active states like Vermont, we need adequately funded federal subsidy and rehabilitation grant programs to augment tax credits, tax exempt financing, and the

creative financing techniques that we are using to save this housing.

In this national crisis there is a role for each level of government. If the responsibility is shared, as is contemplated with Northgate, the threat of displacement and homelessness can be converted into a sound, long-term solution to our affordable housing need. Moreover, if a strong non-profit housing sector is created in the process, we will have developed a more cost effective use of our housing subsidy dollars and laid the groundwork for a new era in affordable housing policy.

Thank you for the opportunity to comment.

LANDON PROPERTIES INCORPORATED

Dale C. Landon, President

June 15, 1989

The Honorable Alan Cranston
Senate Subcommittee on Housing and Urban Affairs
535 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: Preservation of Low Income Housing

I. Introduction

As an owner of a 221D(3) apartment complex which was eligible for prepayment on November 1, 1988, I greatly appreciate this opportunity to provide an owner's perspective on the above referenced issue. Having spent well over a year trying to deal with the confusing, frustrating implementation of the Housing and Community Act of 1987 ("the 1987 Act"), I bring to the table a very real, first hand knowledge of the impact of the 1987 Act on both owners and tenants. This paper will summarize my specific experience in trying to deal with the 1987 Act and then move to general, conceptual observations and solutions. Hopefully, my direct experience will prove useful in the formulation of viable solutions to this element of the very real affordable housing problem facing this country.

II. Concord Green Apartments - 130 Units, Concord, California.

Date of final endorsement: October 16, 1968.

Sold to current owner July 31, 1985.

Price: $4.6 million. Appraised value as a deregulated property as of August 1988: $9.6 million (assuming improvement expenditures of $500,000).

Acquisition funds provided by a combination of investor equity and an independent, third party loan calling for interest accrual at a variable rate of approximately 17% per annum, compounding quarterly. Due date on the loan - July 31, 1989.

Current owner's original objectives: Refinance both the 221D(3) loan and the accruing loan on November 1, 1988 thereby eliminating regulatory restrictions; improve property and phase in rent increases over three to five years to realize fair market value of the property.

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Current owner's objective in light of the 1987 Act: Negotiate with HUD and implement expeditiously a package of incentives which will enable the owner to refinance the accruing loan and realize a fair return on investment while maintaining the property as low income rental housing for the remaining term of the 221D(3) loan.

III. Chronology of Negotiations.

February 1988 - 1987 Act signed into law. Prepayment notification sent to HUD. Request is made for Plan of Action form.

August 1988 - Meet with senior HUD officials in Washington. Stress the urgency of quickly refinancing the accruing loan. Receive assurance that Concord Green is a top priority and will be handled expeditiously. Receive formal Plan of Action requirements.

September 1988 - Submit Plan of Action to HUD San Francisco, together with HUD required appraisal.

October 1988 - 20 year lock-in period expires. Balance of accruing loan is $3,042,000.

November 1988 - Prepayment request denied. Balance of accruing loan = $3,064,000.

December 1988 - Receive verbal recommendation from HUD San Francisco 84 units of Section 8 assistance to cover the very low and low income tenants plus 241F insurance for new 2nd. trust deed loan. Assured that recommendation will be sent to HUD Central by 1st. of January. Balance of accruing loan = $3,096,000.

January 1989 - Recommendation has not been sent to HUD Central. Will be out by January 19. Due to delays, the project now requires 94 Section 8 units to support new loan and a fair return. Balance of accruing loan = $3,123,000.

March 1989 - Recommendation submitted to HUD Central; immediately recalled. No Section 8 will be provided to low income tenants. Receive disapproval of Plan of Action notification. Balance of accruing loan = $3,165,000.

May 1989 - Meet with HUD San Francisco senior officials. After several lengthy meetings, verbally agree on an incentive package which will enable refinancing of the rapidly accruing existing loan but will not provide a return on investment for at least three years (and then only 5% on invested capital). Submitted a letter outlining agreed upon items.

June 1989 - Receive letter from HUD San Francisco stating different terms than had been verbally agreed upon, the net result of which would put the property in financial distress. Regional Administrator to meet with HUD Central to see what can be worked out.

July 1989 - The balance of the accruing loan will be $3,258,000.

It has been nine months since submission of the original Plan of Action. The process has cost the owner in excess of $35,000 in legal and appraisal fees, over $200,000 in additional interest expense, and a substantial amount of lost rent. The matter remains unresolved.

The purpose of the aforementioned chronology is not to point the finger of blame at HUD, Congress or anyone. It is to demonstrate by case in point that the 1987 Act is not working as intended. There are numerous reasons why HUD has been unable to bring negotiations with the owner to closure and to fulfill the fair return requirements legislated in the 1987 Act. Regardless of the reasons, the effect of the process has been unbelievably frustrating and very close to disastrous. For sixteen months the tenants have remained in an uncomfortable state of limbo, not knowing what is going to happen to their apartment; and the owner has incurred substantial costs of sweat equity and cash - a bitter reward for a sincere effort to work within the system.

Major overhaul is needed. It is my hope that out of this forum will be derived a framework for viable, fair solutions to the preservation problem which can be implemented quickly.

IV. What is right? What is fair?

I speak as one American, but I believe my views are shared by the majority. It is a tragic state of affairs in a country as wealthy as the United States that a certain percentage of the populace cannot afford decent, safe, sanitary housing. We are not here to debate the why's and wherefore's of this state of affairs; we must accept it as a stipulated fact.

Given this fact, it is the "right" thing to do for this country to allocate some of its resources to rectify the problem. Shelter is a basic need. The United States can ill afford the potential social unrest which may result from a failure to positively address and fulfill that need. The least expensive way to solve part of the problem is to preserve existing housing originally constructed for low income use. It is far cheaper to preserve than to replace. But it is not "right" to confiscate property from owners who have fulfilled their contractual obligation with the government.

The question then becomes: Who should pay for preservation - a select group of owners or the country as a whole? The housing affordability failure is not the doing of the owners; it is a failure of the national system to insure a minimum acceptable economic wherewithal for all of the people. It is a national problem, and, therefore, it is "fair" that the burden of providing low income housing should be borne by the nation as a whole. It is patently unfair to allocate a disproportionate tax burden to the owners of low income properties just because it may be the path of least resistance. That is the real affect of the 1987 Act, and it is this inequity which must be corrected.

V. Solutions

A. Economic Perspective.

I believe there has been an erroneous estimation of the magnitude of the loss of low income housing units due to prepayment. It is highly unlikely that a majority of owners would opt out of the program for the simple reason that there is little economic incentive for them to do so. In most regions, the differential between restricted rents and market rents is insufficient to justify the risk and cost of converting to a market rate property, particularly when the owner has to replace the existing low interest rate loan with a market rate loan. The problem, for the most part, is a bi-coastal one where developable land is scarce and property values and rents have escalated dramatically over the last twenty years.

The desired objective, therefore, of having those owners who might find it economically beneficial to prepay retain their properties for low income tenancy should not be accomplished through government edict, but rather through economic inducement. There is an after tax cash return monetary equilibrium point for every property in every market at which the owner should be indifferent with respect to staying in the program. The level of inducement required to reach that equilibrium point is relatively easy to compute. A fair market, deregulated rental income potential for any given property can be determined through independent appraisal. From that rental level subtract the tenants' rent (at 30% of income) and the cash flow differential between market rate financing and the existing HUD loan. The remainder, if any, is the amount of federal subsidy required to induce the owner to stay in the program.

B. Incentives.

Because the motivations and needs of owners will vary, inducement should take the form of a basket of incentives, with any or all available to each owner as long as the sum of the incentives does not exceed the equilibrium point. (Owners should not realize an after tax return greater than that available in the free market.)

Rate of Return:

Following the logic of economic equilibrium, the owner's return should not be preset, but should be a function of the free market rental income stream of the property (as adjusted) and the owner's management efficiency. Obviously, periodic inspections by HUD would be required to ensure that the property was being adequately maintained.

Project Based Section 8 (or other recurring direct cash subsidy):

Should cover a sufficient number of units to reach the equilibrium point, regardless of whether the tenant is very low, low, or moderate income. Should have annual increases corresponding directly to fair market rent increases. Should be coterminous with the required low income use term.

Secondary Financing:

All prohibitions to secondary financing should be repealed. Given the virtual impossibility of a second lender foreclosing on a HUD insured property, 241F or other government insurance should be available for any second loan, regardless of the originator. Additionally, Fannie Mae or Ginnie Mae should have a mandate to purchase these loans. Finally, the cost of obtaining the loan (points, insurance premium, etc.) should be kept to an absolute minimum. There is no logical reason for the insurance premium on a 241F loan to be 1% per annum when most, if not all, other HUD insurance premiums are 1/2%.

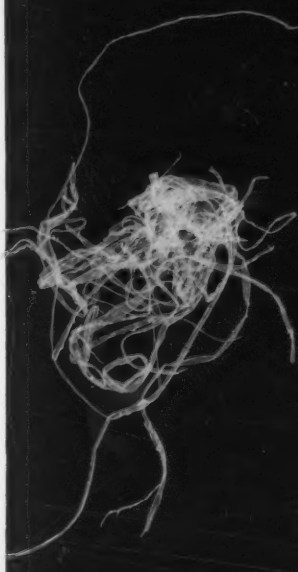
Capital Improvement Loans:

Should be available at very low interest rates (1% - 3%) on a 3:1 loan to owner contribution ratio. The loans should be coterminous with the underlying first, but should be either interest only or amortize over a minimum 40 year period so as to not adversely impact cash flow.

Tax Incentives:

Forgive capital gains tax on sale to a new owner who agrees to retain low income usage. Sale price would be discounted to equal deregulated fair market value less a percentage (say 50%) of the tax due on seller's gain. (If the discount was 100% of the tax due, the owner would have no incentive to sell.)

Provide nonrecapturable tax credits and/or deductions against all forms of income for owners staying in the program. This is less expensive than direct subsidy since, at current marginal rates, 77 cents of tax credit provides the same benefit as 1 dollar of subsidy. It is also less expensive to administer.



C. Purpose.

Concord Green is a case in point where the intended use of the property - decent housing for low income families - is to a large extent no longer being realized. I doubt that it is the exception. Approximately one-third of the tenants are at moderate or market income levels, and several are households without children. The owner has no authority to displace existing tenants.

The new Act should address the intended use issue. At a minimum, turnover units should be rented to very low income families at 30% of income. Direct subsidy for these turnover units should be available so as to maintain the economic equilibrium of the property. I would go a step further and require that tenants who no longer qualify due to increased income or no more children at home be required to relocate within a reasonable time period, say six months. Taxpayers should not subsidize housing for those who no longer qualify.

D. Administration.

I am not familiar enough with the inner workings of HUD to make a definitive statement as to where this program should be administered. My feeling is that it should be handled by a separate department at HUD Central which would have total responsibility and decision making authority.

Regardless of where the decisions are made, speed is absolutely essential. Ninety days should be more than enough time from submission of a Plan of Action to implementation. In my opinion, the program is doomed to failure if the process continues to require the time frame experienced thus far under the 1987 Act.

Statement presented to

Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate
Alan Cranston, Chair

Roundtable on Low Income Housing Preservation

by
Barbara H. Percy
ACORN
The Association of Community Organizations for Reform Now

June 20, 1989

My name is Barbara H. Percy and I am the Chairperson of the Hillvale ACORN Tenants Association (H.A.T.A), located in St. Louis, Missouri. Our organization is very embryonic and was formed in November 1988 out of the necessity to try to prevent our landlord (owner) from charging exorbitant rent increases.

Hillvale Apartments was built in 1968 as a 221(d)3 project. Hillvale has 146 units of two and three bedroom apartments. In 1988, the owner, Mr. Dan Wald, prepaid the mortgage. Thus, according to his understanding, because the property was no longer covered by any federal insurance, he was freed from any government regulations.

Presently, this case is pending litigation in U.S. District Court and is known as the *Johnson et. al. v. HUD* case.

Major Issues:

I. The Banking and Finance Committees should consider:

a. Increasing the present budget for subsidized housing (e.g. devote two cents of each tax dollar to housing).

b. Supporting legislation that pertains to the revision on the 1987 Housing and Community Act.

II. a. HUD should support tenants and not back owners where prepayment has occurred.

b. Incentives should vary based on the resources of the owners, i.e., have different criteria for different owners of federally subsidized housing.

c. Different types of community needs should also be considered, e.g., age of occupants, employment situation, family size etc.

d. HUD should provide each tenant a handbook with guidelines and as changes occur, periodically, this handbook should be revised.

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III. a. Extend the moratorium for at least an additional two years.

b. Have strict penalties for early prepayment or withdrawal from federally subsidized programs.

c. Develop a long range plan that will assure low and moderate income housing well into the 21st century and beyond.

In closing, I feel we need a concerted effort on the part of local, state and federal governments working together to help solve the problems now facing America as it relates to subsidized housing. I also appreciate the fact that tenants such as myself are having more input into the decision making process that will affect about 10,000 units in Missouri alone and over 300,000 units across the country.

If affordable housing for low and moderate income families is not maintained and expanded, countless more families will be displaced and join the growing population of the homeless.

REVISED DRAFT

NORTHEAST STATES' PROPOSAL ON FEDERAL INCENTIVES NEEDED TO PRESERVE ASSISTED HOUSING

REVISED JUNE 19, 1989

DRAFT
NORTHEAST STATES' PROPOSAL ON FEDERAL INCENTIVES NEEDED TO PRESERVE ASSISTED HOUSING

I. Introduction.

The preservation of federally assisted low income housing is of critical importance. It is estimated that up to one million assisted units nationally could be removed from low income occupancy in the next decade as a result of prepayment of mortgages and the termination or expiration of subsidy contracts.

This proposal is the result of a consultative process among the housing commissioners of the six northeast states. These states, Massachusetts, New York, New Jersey, Maryland, Connecticut, and Rhode Island, have an extensive inventory of assisted housing with the potential for termination of low income occupancy. The proposal represents a consensus on a recommended approach for Congress to follow.

This paper outlines the principles that should govern the approach to preservation of assisted housing, describes incentives which could retain much of the existing supply of assisted housing, sets forth the disincentives which should be established if, despite the incentives offered, an assisted project owner is determined to terminate low income occupancy and, lastly, outlines an administrative process which should be established to define appropriate federal and state roles in dealing with the problem.

II. Principles

The following are the key principles which should guide the efforts of federal and state governments in the preservation of assisted housing:

A. Preservation of low income occupancy should be for as long as possible but at least as long as the original term of the federal assistance including all renewal options.

B. Congress should, in law, declare the preservation of assisted housing for low and moderate income tenants a national priority, dedicate

financial resources and direct HUD to utilize its programs and resources fully for this purpose.

C. Resolution of this issue must both protect the low income tenants and balance their needs with the property owners' rights to a reasonable return and reasonable rights to disposition of their property.

D. Incentives used to preserve the existing supply should be at the least public cost. In general, this is likely to mean that greatest efforts should focus on concessions which will induce current owners to continue in ownership or to sell to new owners with assumptions of the existing mortgage and subsidy contract. The chief goal should be to induce sponsors to agree to "lock-in" and complete their original commitments and to agree to give up their rights to terminate federal assistance.

E. The federal government's role in the preservation of assisted housing should be to bear the primary financial costs and for HUD to fully utilize the tools it has to induce owners to remain as sponsors of assisted housing or to facilitate the sale of the housing to sponsors who will complete all the original contractual agreements. The federal government must expand the resources available to preserve assisted housing including, tax-exempt bonds for equity take-out financing and refinancing, low income housing tax credits, and Section 8 funds for rent increases.

F. The role of state government should be to: develop an overall state strategy for the preservation of housing; access and allocate resources from a new pool of preservation resources to the most critical housing prepayment situations; provide technical assistance; and package incentives which have been previously agreed to by HUD as part of the state preservation strategy. The preservation problem is too large and HUD's resources too limited to solve this problem through individual HUD project negotiations. State capabilities and strategies must be a part of the process.

G. The federal government should not postpone dealing with this issue through enactment of an extension of the present "moratorium". It is time to define national policy and take action. An additional moratorium will unfairly negate the owners property rights, as well as compound the problems which will occur when the moratorium is lifted.

III. Incentives

This section lists incentives which can help retain assisted housing. Some would require changes in HUD requirements and some would require federal legislative and budget action. These incentives apply primarily to owners who will retain ownership, but, in some instances, the incentives apply to the purchase of existing assisted housing. These incentives should be offered only if the existing or new owners agree to maintain the housing for at least the remainder of the original terms.

A. Changes In HUD Requirements

There are a number of regulatory and policy changes which HUD could make within existing law which could foster preservation of assisted housing. Most of these incentives are detailed in the 1987 law as allowable in the face of an owner's stated intent to prepay. To date HUD appears most reluctant to utilize these options. HUD must affirm from a policy standpoint that these tools are available and may be relied upon in project negotiations. These incentives should also be allowed selectively for sponsors who are not proposing to prepay, but simply seek better business arrangements in order to continue ownership.

1. Access to Reserve Funds

Current federal regulations require sponsors of federally assisted or insured projects to make deposits to reserve accounts for residual receipts and capital replacements and improvements. All project cash flow in excess of approved annual return on equity must be deposited in a residual receipts account. A fixed monthly deposit to a reserve for replacement account is also required. The balances in these accounts build up over time and under current regulations these funds cannot be accessed by project owners. Access to excess reserve funds could provide property owners with cash resources that will reduce the incentive to prepay loans or terminate assistance contracts. Proposed changes related to the two types of reserve funds are as follows:

a. Residual Receipts

Release of residual receipts to property owners. This action in combination with other incentives may be an alternative to refinancing the project to recover equity. (The federal regulations governing residual receipts are in 24CFR, Part 880.601 for Section 8 New Construction and 24CFR, Part 881.601 for Section 8 Substantial Rehabilitation. The administrative rules governing residual receipts accounts are in Handbook 4350.1, Chapter 4, Section 10, Page 9).

b. Reserve for Replacement

Release of a portion of reserve for replacement funds to project owners. Prior to undertaking this form of relief an assessment of the property's physical condition should be undertaken. If no major replacements are anticipated all funds in excess of two years of reserve for replacement deposits might be released. (The federal regulations governing reserve for replacement accounts are in 24CFR, Part 880.602 for Section 8 New Construction and 24CFR, Part 881.602 for Section 8 Substantial Rehabilitation. The administrative rules governing reserve for replacement accounts are in Handbook 4350.1, Chapter 4, Section 10, Page I).

2. Access to Excess Income

Currently Section 236 and Section 221(d)(3) unsubsidized market rents are established at levels lower than fair market rents (FMR's) for Section 8 projects. In order to increase project cash flow, Section 236 and Section 221 (d)(3) unsubsidized market rents should be raised to the level of Section 8 existing FMR's or to actual market rents, subject to tenant affordability.

Current regulations governing the Section 236 and Section 221(d)(3) Below Market Interest Rate (BMIR) Programs also require repayment to HUD of all rental income in excess of the HUD approved basic rent. This excess income represents a resource which could be used to pay debt service on subordinate financing without placing an increased rent burden on the lower-income tenants of the development. Allowing property owners to retain excess income from rents for approved purposes in lieu

of remitting the funds to HUD could be a strong incentive in certain market areas.

This incentive would need to be structured in such a way as to ensure owners are not motivated to rent a disproportionate number of units to families who can afford market rents. Also it may be difficult to secure HUD approval of this incentive since the excess income is used by HUD to fund the Flexible Subsidy Program and the new Capital Loan Program. Excess income is the only funding resource for these two programs. (The federal regulations governing excess income are in 24CFR, Parts 236.60 and 21.514. The administrative rules governing excess income are in Handbook 4350.1, Chapter 4, Section 3, Page 16. This change appears to also require a legislative change).

3. Increased Return on Equity

a. Annual Return on Equity

Current regulations for most of the assisted housing programs have requirements which limit the annual return on equity to between six and eight percent. These limits on return on equity provide disincentives for maintaining assisted housing, particularly if the project is generating increasing annual surpluses which create taxable phantom income. Removing these percentage restrictions or increasing the approved percentage return is an incentive which could encourage property owners to maintain assisted housing. (The federal regulations governing annual return on equity are in 24CFR, Part 880.205 for Section 8 assisted projects and 24CFR, Part 236.10 for Section 236 and Section 221(d)(3) BMIR projects. Administrative rules governing annual return on equity are in handbook 4370.1, Rev-1, Section 5, Paragraph 2-15).

b. Equity Basis

Current regulations provide for calculating annual return on equity based on the actual equity contribution at the time a project is developed. This method artificially suppresses return to the sponsor because it fails to consider market and value changes. HUD should permit increases in the equity basis on which return on equity is calculated based upon the greater of current market value of a project or actual equity contributed to a project after final

endorsement. Current market value for assisted projects needs to be determined in consideration of the differential in interest costs that would be experienced upon prepayment of preferential interest rate mortgages and costs of converting to market rate housing such as short-term rent loss, improvement costs, recording taxes, and financing costs.

4. Financing, Insuring and Assuming Mortgages

Providing financing and insurance to existing owners and permitting new owners to assume assisted mortgages and related subsidy contracts, may be the most important set of incentives needed to preserve assisted housing. Reasonable requirements in these areas could encourage existing owners to meet the full term of the obligations in their original mortgages and subsidy contracts or encourage the sale of projects to buyers who will maintain the original obligations for low-income occupancy.

a. Financing Equity Take-Out

Currently HUD is approving subordinate financing only for project improvements and, in many cases, is limiting rent increases to amounts which are insufficient to repay the loan. HUD should permit subordinate mortgages to finance rehabilitation or equity take-out. If necessary, HUD should approve rent increases adequate to repay the debt service on equity take-out loans. However, equity take-out should probably be limited to no more than two-thirds of a project's accumulated equity (the approximate net proceeds after taxes which an owner could achieve through a sale). For certain types of projects rent increases for lower income tenants may be avoided if HUD permits owners to retain excess income (see Paragraph B. above) to repay debt service on subordinate mortgages.

One way to permit equity take-out financing without increasing rents or affecting the federal budget would be zero coupon financing with a balloon payment. This financing method may be most viable when the project generates an income stream with deposits to residual receipts or reserve for replacement accounts which are sufficient to create a fund to retire the zero coupon bond. HUD insurance of zero coupon equity take-out financing could also work to facilitate this approach. (Federal regulations governing

subordinate financing are in Federal Register Volume 53, No. 65, Parts 241 and 248).

b. Insuring Equity Take-Out

HUD recently authorized the 241(f) Program which can provide mortgage insurance for equity take-out mortgages. Despite this new insurance vehicle HUD does not appear to be receptive to insuring mortgages which fund equity take-out. HUD should fully utilize this new authority to insure subordinate mortgages which finance equity take out including balloon mortgages financed by zero coupon bonds.

c. Refinancing

HUD currently does not allow refinancing of mortgages which are subject to interest reduction agreements under the Section 236 and Section 221(d)(3) BMIR Programs. If sponsors are able to secure funds to refinance existing mortgages and fund equity take out, HUD should approve application of existing interest reduction agreements to the new mortgages. This could be an important incentive in the proper interest rate environment when the debt service on the new larger mortgage could be comparable to the debt service on the original mortgage.

d. Assumption of Assisted Mortgages

HUD currently permits assumption of mortgages by buyers of assisted housing who agree to maintain the housing for low-income rental, however, HUD standards for assumptions are rigid and are often a disincentive to preserving the assisted housing. HUD should develop clear criteria for approving assumptions. HUD should approve assumptions with subordinate financing for property improvements and for equity take-out. HUD should also consider permitting assumption and subordination of existing mortgages in order to use other financing which has statutory or regulatory requirements for first mortgages.

5. Sale of HUD Held Mortgages

In some parts of the country HUD holds title to a number of assisted rental properties. Sale of these properties at a very deep discount to buyers who will maintain the original subsidy terms would facilitate low income occupancy.

B. Incentives Requiring Legislation

1. New Federal Resources Needed

There are three federal resources which are critical to the solution of this problem, tax-exempt bonds for project refinancing and subordinate financing for equity take-out loans, low income housing tax credits to make project preservation financially feasible, and federal subsidies to cover necessary rent increases. All three of these resources should be authorized by Congress to a National Housing Preservation Incentives Fund, administered by HUD. States would make application to HUD for these resources as needed to prevent project prepayments. These resources would be allocated to the States through a dedicated set-aside, with a small discretionary pool set aside for the Secretary for special projects based primarily on need related to the number of units eligible to prepay or subject to the possible termination of subsidies. The discretionary pool would be used for projects which unexpectedly come up for prepayment or projects which need resources which exceed those available in the dedicated set-aside. When establishing allocations HUD would also take into consideration other housing and economic conditions in the State or localities in which covered projects are located. These resources, like the other incentives described previously, should only be provided to owners willing to agree to "lock-in" their commitments for at least the remainder of their original terms. Specifically the needed resources are:

a. Tax-exempt Revenue Bonds

Currently there is no below-market interest rate source of funds to finance subordinate debt for equity take-out or to refinance projects. Tax-exempt bonds could be a viable funding source for this purpose if changes to tax law were made to permit the proceeds of tax-exempt bonds to refinance other debt or finance equity take-out for assisted projects.

The current volume caps for tax-exempt bonds are not adequate to address housing production needs as well as address financing sale of existing assisted housing. A special tax-exempt volume cap for the National Housing Preservation Incentives Fund, should be authorized by Congress. When awarded by HUD, the necessary bond cap would be transferred to the appropriate issuer.

b. Low-Income Housing Tax Credits for Preservation

Low-Income Housing Tax Credits have become an important, and highly sought after, tool for the production and rehabilitation of housing. As currently proposed Low-Income Housing Tax Credits may be used only for newly acquired projects which were last placed in service over ten years prior to the sale of the project and for rehabilitation of existing projects.

Tax credits should be available to assisted housing which is eligible for prepayment, in exchange for an agreement to continue low-income occupancy for the longer of the term of the mortgage or subsidy contract or the tax credit income compliance term. The income limits for these tax credits would need to conform with the existing income limits for the projects. As with the revenue bonds described above, tax credits for this purpose should be authorized as a separate allocation to the national pool apart from the regular tax credit allocation.

c. Funds for Rent Subsidies Increases

HUD needs to provide additional subsidies which can be used to cover the increased costs necessary under various incentive plans outlined in this paper. For example, secondary financing or refinancing for equity take-out will require additional debt service. Increased subsidy payments will in many cases be required to make this a workable incentive. Section 8 for these purposes could also be administered as part of the national pool, with subsidy contract authority being separately set aside for housing preservation and for specific states interested in managing a local housing preservation initiative in coordination with HUD.

More specifically, the provision of additional rental subsidies to support the preservation of expiring use properites should be based on the following principles:

1. Given that HUD has articulated a policy of commitment to provide subsidy assistance for "opt-outs," the same commitment should be extended to properties which agree not to prepay if the Section 8 subsidies are needed to preserve existing low income occupancy.

2. In cases in which Sectin 8 assistance is already in place in a property (e.g., Loan Managment Set Aside), it is essential that the

subsidy be allowed to increase to a level (e.g., Fair Market Rents) adequate to support the costs of the preservation plan.

3. Given that current Section 8 subsidy contracts are generally for only a five-year period, HUD should make provision for strengthening the long-term nature of the subsidy commitment. This could be accomplished through some form of "back-up" commitment that would take effect after the termination of the five-year contract or some other mechanism to insure continuity in the subsidy over time that will be needed to support long term debt.

2. Other Tax Law Changes

a. Passive Losses

Changes to tax law in 1986 removed many of the incentives for existing owners to maintain assisted housing. Tax laws should be amended to permit existing owners of assisted projects who were eligible to claim passive losses as federal tax deductions prior to the Tax Reform Act of 1986 to continue to claim passive losses, or provide existing owners a bonus basis in an amount up to a current value of the project. This amount could be depreciated over the remaining term of the mortgage in exchange for maintaining low-

b. Capital Gains

Tax relief could be provided for capital gain on sale of assisted projects, if the sale restricts the project for continued use as low-income housing. Such relief could be provided through a payment of tax liability over a period of up to five years. The capital gains relief should be granted only on sale of the project to a public housing authority, local government, tenant association, nonprofit organization, or a profit motivated purchaser. Sales to profit motivated organizations should be conditioned upon the purchaser agreeing to keep the project for low-income use for the longer of the term of the mortgage or assistance contract or any longer term required by the State plan.

3. Creation of a HUD Office of Affordable Housing Preservation

This proposal is a part of the Senate housing proposal. It would be a good idea to establish such an office in order to pull together the expertise

necessary for HUD to act in a responsible and efficient fashion. This office might also be the appropriate vehicle for the administration of the National Housing Preservation Incentives Pool which would be allocated to the most critical preservation situations consistent with state applications.

IV. Disincentives

In some market areas a package of incentives alone may not be adequate to discourage owners from prepaying mortgages and terminating assistance contracts. To encourage owners to pursue incentive packages rather than converting to market rentals or condominiums the federal government should establish disincentives intended to discourage conversion or at least, make it possible only after minimum tenant protections are in place. The basic criteria for a federal law should require owners to do the following:

A. Notice of Intent

Give at least one but not more than two years written notice of intent to prepay a federally assisted mortgage or discontinue federal subsidies. The notice would be given to HUD, the State, local government, local public housing authorities and tenants.

B. Right of First Refusal

Offer a right of first purchase to public housing authorities, local governments, tenant associations, nonprofit organizations and profit motivated purchasers willing to preserve low income occupancy.

C. Relocation Assistance

Owners would be required to develop relocation plans which address procedures for assisting with relocation and providing moving expenses for all displaced assisted tenants, up to a modest limit of, for example, $1,000 a household.

D. Post Payment Restrictions

Provide post payment restrictions which benefit all assisted households such as a one year lease extension and an additional 2 year lease extension for a portion of the assisted housing tenants who meet priorities such as elderly, handicapped, or single parent households,

right of first refusal to tenant families in the event of conversion to condominium, and limits on rent increases during extended lease terms.

A federal law modeled on these principles should be enacted and become effective immediately upon the expiration of the present federal moratorium, in February 1990. The law should give States the option of adopting more stringent requirements based upon state priorities and objectives.

V. Administrative Proposal for State Participation

Any new federal law dealing with the preservation of expiring use properties should contain an Administrative Plan which will describe precisely the Federal, State, Local, Owner and Tenant roles at various stages of the preservation process.

Reliance on a moratorium as the sole solution for resolving the expiring use issue has little likelihood of success over the long term. The Federal Government must exert a proactive role in the matter and take steps to solve the problem.

It is clear that the Federal Government must take the lead financial role for the preservation of assisted housing. The problem is a federal one and the cost greatly exceeds what states or localities can fund. Without question, the federal role in preserving federally assisted housing must be to bear the financial burden for the provision of subsidies and to reliably permit the use of the HUD controlled incentives listed previously.

It is, therefore, clear that state and local governments will not step forward without HUD. However, HUD does not currently have sufficient staff to handle the individual project negotiations necessary to prevent mortgage prepayments and subsidy terminations. States, on the other hand, have, through their designated departments, offices or housing finance agencies, the experienced staff and the local knowledge which could be used to deal effectively with the problem. In a true administrative partnership where HUD establishes criteria for developing state plans of action and parameters related to the incentives and flexibilities permitted, the Federal Government would coordinate it's actions with the state and local governments in the development of preservation plans. Under such plans states could apply for and package

federal resources -- bonds, tax-credits and subsidies -- and allocate them to projects where termination of low income occupancy is imminent or coordinate such actions by HUD.

Specifically the role of states should be as follows:

1. Develop state policies and strategies for dealing with projects proposing to terminate low income occupancy. These strategies would include identification of the likely magnitude of the problem within the state, identify projects where prepayment or subsidy termination is eminent or has been requested, and identify the kinds of federal resources necessary to deal with the eminent prepayment projects, and set forth the various flexibility from HUD regulations likely to be necessary in project negotiations.

2. Based on the state plan and the imminent prepayment projects in the state, states would apply to HUD for resources necessary to prevent termination of low income occupancy in federally assisted housing. As described previously, a National Housing Preservation Fund of tax credits, tax-exempt bond volume, and federal subsidies should be established. The Fund would work in a similar way to a line of credit allocated to each State on a dedicated set-aside basis. The Fund would be accessed through the negotiated agreements with project owners for assisted projects in danger of terminating low-income occupancy, with HUD approval of the agreement based solely on whether the agreement is within the program parameters, State allocation and approved State plan. These resources would, as noted, be applied for by states and awarded based on projects actually proposing to terminate low income occupancy.

3. As defined in the State action plan, States would provide technical assistance to existing and prospective owners and negotiate agreements with the project owners or coordinate negotiation of agreements between HUD and project owners incorporating a project specific mix of assistance from the National Housing Preservation Fund and other incentives (e.g., flexibility in HUD regulations as described in Section III, page 3). HUD would set advance program parameters for approval of such agreements. HUD would agree in advance to the kind of flexibility it would permit. States would use these parameters to guide their negotiations with project sponsors. States, if they had the interest and technical ability, would act as negotiators and brokers to package these deals to prevent prepayment. HUD would have to approve the final package, but if all the previously

agreed upon principles were correctly implemented, HUD would not renegotiate or second guess the state proposal.

The role of HUD would be as follows:

1. Designate contact persons for specific projects or States depending upon the level of State authority approved in the State plan of action.

2. Provide States with complete lists of federal resources available to support the States' action plans.

3. Approve State action plans.

The joint federal and State role would vary from State to State depending upon the level of State involvement provided for in the State action plan.